MISCELLANEOUS TAX BILLS III

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FIFTH CONGRESS

SECOND SESSION

ON

H.R. 810, H.R. 4030, H.R. 5099, S. 1611, S. 2771, S. 3049, S. 3176, S. 3345

AUGUST 28, 1978

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CONTENTS

ADMINISTRATION WITNESSES

Page

Halperin, Daniel, Tax Legislative Counsel, Treasury Department 354

PUBLIC WITNESSES

American Gas Association, George H. Lawrence, president 370

American Insurance Association, Walter D. Vinyard, Jr 92

American Newspaper Publishers Association, K. Prescott Low, publisher, the Patriot Leader, Quincy, Mass., and chairman of the Tax Law Task Force, accompanied by W. Terry Maguire 393

Becker, Ernest A., president, National Association of Home Builders, accompanied by Robert D. Bannister, senior staff vice president, and Mark Fitzgerald, assistant director of congressional relations, National Association of Home Builders 369

Brotzman, Donald G., vice president, Rubber Manufacturers Association 47

Clements, Robert, on behalf of the National Association of Insurance Brokers, Inc 96

Edison Electric Institute, W. Dean Hudson 366

Friedlund, Robert, on behalf of the Material Handling Institute 100

Hudson, W. Dean, on behalf of the Edison Electric Institute 366

Lawrence, George H., president, American Gas Association 370

Little, Arthur D., first vice president and treasurer, National Association of Small Business Investment Companies, accompanied by Charles Noone 425

Low, K. Prescott, publisher, the Patriot Leader, Quincy, Mass., and chairman of the Tax Law Task Force of the American Newspaper Publishers Association, accompanied by W. Terry Maguire 393

Machinery & Allied Products Institute, Charles W. Stewart, president, accompanied by Charles I. Derr 49

Mack, James H., on behalf of the National Machine Tool Builders' Association, accompanied by Jeff Secrest, vice president, Secrest Machine Co 45

Material Handling Institute, Robert Friedlund 100

Morgan, Hon. Robert, a U.S. Senator from the State of North Carolina, accompanied by Morris J. Levin, Esq., John Siegenthaller, and Alfred Pollard 385

National Association of Home Builders, Ernest A. Becker, president, accompanied by Robert D. Bannister, senior staff vice president, and Mark Fitzgerald, assistant director of congressional relations 369

National Association of Insurance Brokers, Inc., Robert Clements 96

National Association of Small Business Investment Companies, Arthur D. Little, first vice president and treasurer, accompanied by Charles Noone 425

National Machine Tool Builders' Association, James H. Mack, accompanied by Jeff Secrest, vice president, Secrest Machine Co 45

Rubber Manufacturers Association, Donald G. Brotzman, vice president 47

Schopp, Anthony, executive vice president, Machinery Dealers National Association, on behalf of the Small Business Legislative Council 98

Small Business Legislative Council, Anthony Schopp, executive vice president, Machinery Dealers National Association 98

Stewart, Charles W., president, Machinery & Allied Products Institute, accompanied by Charles I. Derr 49

Vinyard, Walter D., Jr., on behalf of the American Insurance Association 92

COMMUNICATIONS

Page
Alliance of American Insurers, Donald L. Jordan, assistant vice president ... 440
American Bankers Association, Robert L. Bevan, associate Federal legislative counsel ... 450
American Institute of Architects ... 442
American Legion, Mylio S. Kraja, director, national legislative commission ... 454
American Mining Congress ... 451
American Telephone & Telegraph Co., Robert N. Flint, vice president and comptroller ... 468
Anderson, Lee, president, Alexander's Sporting Goods, Danville, Ill., on behalf of the National Sporting Goods Association ... 472
Bevan, Robert L., associate Federal legislative counsel American Bankers Association ... 450
Brodhead, Hon. William M., a Representative in Congress from the State of Pennsylvania ... 433
Farm and Industrial Equipment Institute ... 445
Flint, Robert N., vice president and comptroller, American Telephone & Telegraph Co ... 468
Hauss-Helms Foundation, Inc., James E. Weger, president ... 475
Jordan, Donald L., assistant vice president, Alliance of American Insurers ... 440
Kraja, Mylio S., director, national legislative commission, the American Legion ... 454
Laxalt, Hon. Paul, a U.S. Senator from the State of Nevada ... 429
McCamant, William C., executive vice president, National Association of Wholesaler-Distributors ... 466
Mathias, Hon. Charles McC., Jr., a U.S. Senator from the State of Maryland ... 430
National Association of Regulatory Utility Commissioners ... 481
National Association of Wholesaler-Distributors, William C. McCamant, executive vice president ... 466
National Society of Professional Engineers ... 468
National Sporting Goods Association, Lee Anderson, president, Alexander's Sporting Goods, Danville, Ill ... 472
Nelson, Hon. Gaylord, a U.S. Senator from the State of Wisconsin ... 432
Price, Hon. Ned, member, acting chairman, Texas State Board of Insurance ... 456
Southern California Edison Co ... 447
Traxler, Hon. Bob, a Representative from the State of Michigan ... 435
Walters, Johnnie M., of Hunton & Williams ... 448
Weger, James E., president, Hauss-Helms Foundation, Inc ... 475

APPENDIX

Description of tax bills listed for a hearing before the Subcommittee of Taxation and Debt Management on August 28, 1078 ... 484

Additional Information

Committee press release ... 1
Text of the bills H.R. 810, H.R. 4030, S. 1611, S. 2771, S. 3049, S. 3176, S. 3345 ... 3
Products Liability: A MAPI Survey ... 50
Letter to Senator Byrd from the Association of American Railroads ... 367
Article: "The Press's Great Threat—It's Not the Supreme Court's Decision, But the New Owners Themselves," by Richard Reeves ... 390

MISCELLANEOUS TAX BILLS III

MONDAY, AUGUST 28, 1978

U.S. SENATE,
COMMITTEE ON FINANCE, SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT GENERALLY,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2221, Dirksen Senate Office Building, Hon. Harry Byrd (chairman of the subcommittee) presiding.

Present: Senators Byrd, Jr., of Virginia, Packwood, and Laxalt.

[The committee press release announcing this hearing and the bills H.R. 810, H.R. 4030, H.R. 5099, S. 1611, S. 2771, S. 3049, S. 3176, and S. 3345 follow:]

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT ANNOUNCES HEARINGS ON MISCELLANEOUS TAX BILLS

Senator Harry F. Byrd, Jr., (I.-Va.), Chairman of the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, announced that a hearing will be held on August 28, 1978, on miscellaneous tax bills.

The hearing will be held on Monday, August 28, 1978, at 9:30 a.m., in Room 2221, Dirksen Senate Office Building.

The following pieces of legislation of general application, unless otherwise noted, will be considered:

H.R. 810, sponsored by Congressman Conable, a bill amending section 4941 of the Code to permit private foundations to pay or reimburse Government officials for expenditures (up to certain limits) incurred for travel outside the United States. It is estimated that this bill will not have any direct revenue effect.

H.R. 4030, sponsored by Congressman Guyer, a bill to increase from 50% to 51% the maximum amount of voting stock that private foundations may hold in certain public utilities without being subject to the excise tax (imposed by section 4943 of the Code) on excess business holdings. It is estimated that the bill will not have any direct revenue effect.

H.R. 5099, sponsored by Congressman Moorhead, a bill for the relief of Brian Hall and Vera W. Hall to make them eligible for nonrecognition of gain treatment under section 1034 of the Code on the reinvestment of the proceeds of sale of their personal residence. It is estimated that the bill will reduce revenues by less than $25,000 for fiscal year 1979.

S. 2771, sponsored by Senator Hathaway, a bill to exempt from the tax on unrelated business income the proceeds from the operation of certain games (such as beano). It is estimated that the bill will reduce budget receipts by about $15 million annually. This estimate does not take into account the retroactive effective date.

S. 1611, sponsored by Senator Culver, a bill to provide a deduction for additions to a reserve for product liability losses.

S. 3049, sponsored by Senators Culver and Nelson, a bill to provide a deduction for amounts placed in a reserve for product liability losses and expenses and for amounts paid to captive insurers.

S. 3176, sponsored by Senator Laxalt, a bill to allow public utilities to exclude from gross income, as contributions to capital, amounts received in aid or con-

struction of electrical energy, steam, or gas facilities. If all the contributions in aid of construction were treated as income, the annual increase in tax liabilities is estimated to be in the range of $180–$200 million. If the electric and gas utilities rely on past treatment and file tax returns as if Revenue Ruling 75–557 applied only to water and sewage companies, and if court decisions are in favor of the utilities, then the proposal to broaden section 2120 of Public Law 94–455 would have no revenue effect because it could be viewed as codifying the historic tax treatment of contributions in aid of construction of regulated public utilities.

S. 3345, sponsored by Senator Nelson, a bill to amend the tax treatment of small business investment companies. It is estimated that the bill would reduce budget receipts by about $200,000 in fiscal year 1979 and less than $500,000 annually thereafter.

Revenue estimates for S. 1611 and S. 3049 are currently not available. The Committee will make revenue estimates available prior to or on the day of the hearings.

Requests to Testify.—Persons who desire to testify at the hearing should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510, by no later than the close of business on Thursday, August 24, 1978.

Legislative Reorganization Act.—Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify must comply with the following rules:

(1) A copy of the statement must be filed by the close of business two days before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 75 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statements to the Committee, but are to confine their five-minute oral presentations to a summary of the points included in the statement.

(5) Not more than five minutes will be allowed for oral presentation.

Written Testimony.—Senator Byrd stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies by September 8, 1978, to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510.

95TH CONGRESS
2D SESSION

H. R. 810

IN THE SENATE OF THE UNITED STATES

MARCH 15 (legislative day, FEBRUARY 6), 1978
Read twice and referred to the Committee on Finance

AN ACT

To amend section 4941 (d) (2) (G) of the Internal Revenue Code of 1954.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That section 4941 (d) (2) (G) of the Internal Revenue Code
4 of 1954 (relating to payment or reimbursement of certain
5 traveling expenses) is amended by striking out "or" at the
6 end of clause (vi), by striking out the period at the end of
7 clause (vii) and inserting in lieu thereof ", or", and by add-
8 ing at the end thereof the following.
9 "(viii) any payment or reimbursement of
10 traveling expenses for travel between a point
11 in the United States and a point outside the

II

2

1 United States, but only if such payment or
2 reimbursement with respect to any one trip by
3 an official does not exceed the lesser of the
4 actual cost of the transportation involved or
5 $2,500, plus an amount for all other traveling
6 expenses not in excess of 125 percent of the
7 maximum amount payable under section 5702
8 (a) of title 5, United States Code, for like
9 travel by employees of the United States for a
10 maximum of 4 days.
11 Clause (viii) shall not apply to any payment or
12 reimbursement made by a private foundation if more
13 than one-half of the foundation's support (as defined
14 in section 509 (d)) is normally derived from any
15 business enterprise, trade association, or labor
16 organization.".
17 SEC. 2. The amendments made by the first section of
18 this Act shall apply to travel beginning after the date of the
19 enactment of this Act.

Passed the House of Representatives March 14, 1978.

Attest: EDMUND L. HENSHAW, JR.,

Clerk.

95TH CONGRESS
2D SESSION

H. R. 4030

IN THE SENATE OF THE UNITED STATES

AUGUST 2 (legislative day, MAY 17), 1978
Read twice and referred to the Committee on Finance

AN ACT

To increase the period during which certain private foundations may continue to hold their May 26, 1969, interests in certain public utilities without being subject to the excise tax on excess business holdings.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. APPLICATION OF SECTION 4943 OF INTERNAL**
4 **REVENUE CODE OF 1954 TO CERTAIN HOLD-**
5 **INGS IN PUBLIC UTILITIES.**
6 (a) IN GENERAL.—In the case of a private founda-
7 tion—
8 (1) which was incorporated on or before Decem-
9 ber 31, 1967;

II

1 (2) which on May 26, 1969, held at least 50 per-
2 cent of the voting stock of a qualified public utility;
3 (3) which acquired such stock solely by gift, devise,
4 or bequest; and
5 (4) no officer, director, or trustee of which is an
6 individual who contributed such stock to such foundation
7 or is a member of the family of such an individual, or
8 who is a member of the family of an individual who
9 devised or bequeathed such stock to such foundation,
10 subsection (c) (4) (B) of section 4943 of the Internal Reve-
11 nue Code of 1954 shall be applied with respect to the hold-
12 ings of such foundation in such public utility as if such pri-
13 vate foundation had a more than 95 percent voting stock
14 interest in such public utility on May 26, 1969. For pur-
15 poses of this subsection, the term "family" has the meaning
16 given to such term by section 4946 (d) of such Code.
17 (b) QUALIFIED PUBLIC UTILITY.—For purposes of
18 this section, the term "qualified public utility" means any
19 corporation—
20 (1) which on May 26, 1969, was a public utility
21 (as defined in section 247 (b) (1) of such Code);
22 (2) the taxable income of which for its first taxable

1 year ending after such date was less than $1,000,000;
2 and
3 (3) which distributed to its shareholders, in any 3
4 of the 5 taxable years preceding the taxable year in
5 which this Act is enacted and in each taxable year end-
6 ing after the date of the enactment of this Act, at least
7 40 percent of its net income remaining after payment of
8 Federal, State, and local taxes for such taxable year.
9 (c) SPECIAL RULE.—For purposes of subsection
10 (a) (2), stock of any qualified public utility held—
11 (1) in any trust created before May 27, 1969, or
12 (2) in any estate of a decedent dying before such
13 date,
14 of which any private foundation is the primary or remainder
15 beneficiary shall be deemed to have been held by such
16 foundation on May 26, 1969.
17 (d) PROHIBITION OF LATER PURCHASES.—Subsection
18 (a) shall apply with respect to the holdings of a private
19 foundation in any qualified public utility only if the founda-
20 tion does not purchase after the date of enactment of this
21 Act any stock or other interest in such qualified public
22 utility.

1 (e) EFFECTIVE DATE.—This section shall apply with
2 respect to taxable years ending after the date of the enact-
3 ment of this Act.

Passed the House of Representatives August 1, 1978.

Attest: EDMUND L. HENSHAW, JR.,

Clerk.

95TH CONGRESS
1ST SESSION

H. R. 5099

IN THE SENATE OF THE UNITED STATES

NOVEMBER 3 (legislative day, NOVEMBER 1), 1977

Read twice and referred to the Committee on Finance

AN ACT

For the relief of Brian Hall and Vera W. Hall.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That for the purpose of determining the tax liability of Brian
4 Hall and Vera W. Hall, husband and wife, under section
5 1034 of the Internal Revenue Code of 1954, Brian Hall and
6 Vera W. Hall shall be deemed to have sold their residence at
7 759 Foxkirk Road, Glendale, California, within eighteen
8 months of the date of the purchase of their new residence at
9 Laguna Beach, California, if they in fact sell such residence
10 in Glendale, California, not later than six months after the
11 date of the enactment of this Act.

Passed the House of Representatives November 1, 1977.

Attest: EDMUND L. HENSHAW, JR.,

Clerk.

IV

95TH CONGRESS
2D SESSION

S. 2771

IN THE SENATE OF THE UNITED STATES

MARCH 21 (legislative day, FEBRUARY 6), 1978

Mr. HATHAWAY introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To exempt veterans' organizations from the unrelated business tax.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) section 513 of the Internal Revenue Code of 1954
4 (defining unrelated trade or business) is amended by adding
5 at the end thereof the following new subsection:
6 "(f) CERTAIN GAMES.—
7 "(1) IN GENERAL.—The term 'unrelated trade or
8 business' does not include any trade or business which
9 consists of conducting qualified games.

II

1 "(2) QUALIFIED GAME.—For purposes of para-
2 graph (1), the term 'qualified game' means any game—
3 "(A) of a type in which usually—
4 "(i) the wagers are placed,
5 "(ii) the winners are determined, and
6 "(iii) the distribution of prizes or other
7 property is made, in the presence of all persons
8 placing wagers in such game,
9 "(B) the conducting of which is not an activity
10 ordinarily carried on on a commercial basis, and
11 "(C) the conducting of which does not violate
12 any State or local law.".
13 (b) The amendment made by subsection (a) shall
14 apply to taxable years beginning after December 31, 1969.

95TH CONGRESS
1ST SESSION

S. 1611

IN THE SENATE OF THE UNITED STATES

MAY 26 (legislative day, MAY 18), 1977

Mr. CULVER introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1954 to provide for a deduction for additions to a reserve for product liability losses.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That section 165 of the Internal Revenue Code of 1954
4 (relating to losses) is amended by redesignating subsection
5 (i) as (j) and by inserting after subsection (h) the follow-
6 ing new subsection:
7 "(i) RESERVE FOR PRODUCT LIABILITY LOSSES.—
8 "(1) GENERAL RULE.—In the case of a taxpayer
9 whose trade or business involves the manufacture, im-
10 portation, distribution, lease or sale of a product with
11 respect to which there is or may be product liability

1 for the taxpayer, there shall be allowed as a deduction
2 under subsection (a) the amount transferred by the
3 taxpayer for the taxable year to his product liability
4 loss reserve account.
5 "(2) DETERMINATION OF AMOUNT.—The amount
6 of the deduction allowed by paragraph (1) shall not
7 exceed the lesser of—
8 "(A) 3 percent of the gross receipts of the tax-
9 payer from the manufacture, importation, distribu-
10 tion or sale of such product, or
11 "(B) the amount which, when added to the
12 balance of the product liability loss reserve account,
13 equals 15 percent of the taxpayer's average yearly
14 gross receipts from the manufacture, importation,
15 sale, lease or distribution of such product for the
16 shorter of:
17 "(i) the period during which the product
18 liability reserve deduction has been taken;
19 "(ii) the five years ending in the taxable
20 year for which the current deduction is taken.
21 "(3) DISALLOWANCE OF DEDUCTION FOR LOSSES
22 PAID OUT OF ACCOUNT.—In determining the amount of
23 the deduction allowable for the taxable year under sub-
24 section (a), no deduction shall be allowed for any
25 product liability paid or incurred during the taxable year

35-992 O - 79 - 2

1 except to the extent that the amount thereof exceeds the
2 balance of the taxpayer's product liability loss reserve
3 account (disregarding any part of such balance attribut-
4 able to income from amounts transferred to the account).
5 "(4) PAYMENT FROM ACCOUNT FOR INAPPRO-
6 PRIATE PURPOSE.—
7 "(A) Except as provided in subparagraph
8 (B), if any amount is paid out of a product liability
9 loss reserve account during the taxable year for any
10 purpose other than the payment of a product liability
11 loss of the taxpayer—
12 "(i) the amount so paid out shall be in-
13 cluded in the taxable income of the taxpayer for
14 the taxable year, and
15 "(ii) the tax liability of the taxpayer for
16 the taxable year shall be increased (after taking
17 into account the amount included in taxable in-
18 come under clause (i)) by an amount equal to
19 50 percent of the amount so paid out.
20 "(B) Subparagraph (A) does not apply to
21 amounts paid out of a product liability loss reserve
22 account within 90 days after the day prescribed by
23 law for filing the taxpayer's return under this chap-
24 ter (including extensions of time) for the purpose
25 of withdrawing that portion of an amount trans-

1 ferred to the account for the taxable year which
2 is in excess of the amount determined under para-
3 graph (2) for the taxable year and which was
4 included in income for the taxable year.
5 "(C) For purposes of subparagraph (A), any
6 use of amounts in a product liability loss reserve
7 account which is inconsistent with the provisions of
8 paragraph (6) (C) shall be treated as a payment
9 of such amounts out of the account.
10 "(5) SPECIAL RULE FOR CONTROLLED GROUPS.—
11 For the purpose of applying paragraph (2) to a tax-
12 payer which is a member of a controlled group of cor-
13 porations, the gross receipts taken into account for the
14 taxable year with respect to each member of the group
15 shall be only those gross receipts properly attributable
16 to that member for the taxable year. For the purposes
17 of this paragraph, the term 'controlled group of corpora-
18 tions' has the meaning given to such term by section
19 1563 (a), except that—
20 "(A) 'more than 50 percent' shall be substi-
21 tuted for 'at least 80 percent' each place it appears
22 in section 1563 (a) (1), and
23 "(B) the determination shall be made without
24 regard to subsections (a) (4) and (e) (3) (C) of
25 section 1563.

1 "(6) DEFINITIONS.—For purposes of this subsec-
2 tion—
3 "(A) PRODUCT LIABILITY.—The term 'prod-
4 uct liability' includes liability for operations after
5 the operation has been completed or abandoned
6 and means liability for damages arising out of phys-
7 ical injuries to persons or property attributable to
8 negligence in, breach of warranty of, or defects in
9 a product manufactured, imported, distributed,
10 leased or sold by the taxpayer.
11 "(B) PRODUCT LIABILITY LOSS.—The term
12 'product liability loss' means a loss attributable to
13 product liability of the taxpayer.
14 "(C) PRODUCT LIABILITY LOSS RESERVE AC-
15 COUNT. The term 'product liability loss reserve
16 account' means a trust created or organized in the
17 United States for the exclusive purpose of paying
18 product liability losses sustained by the taxpayer—
19 "(i) the trustee of which is a bank (as
20 defined in section 401 (d) (1)) or another per-
21 son who demonstrates to the satisfaction of the
22 Secretary that the manner in which that other
23 person will administer the trust will be con-
24 sistent with the purposes for which the trust is
25 established,

1 "(ii) the assets of which will not be com-
2 ingled with other property except in a common
3 trust fund, and
4 "(iii) the assets of which may not be bor-
5 rowed, used as security for a loan, or otherwise
6 used by the taxpayer for any purpose other than
7 the payment of product liability losses by the
8 taxpayer.".
9 SEC. 2. The amendments made by this Act apply to
10 taxable years beginning after December 31, 1977.

95TH CONGRESS
2D SESSION

S. 3049

IN THE SENATE OF THE UNITED STATES

MAY 9 (legislative day, APRIL 24), 1978

Mr. CULVER (for himself and Mr. NELSON) introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1954 to provide for a deduction for certain amounts paid into a reserve for product liability losses and expenses, to provide a deduction for certain amounts paid to captive insurers, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION. 1. SHORT TITLE.**
4 This Act may be cited as the "Product Liability Self-
5 Insurance Act of 1978".
6 **SEC. 2. SELF-INSURANCE FOR PRODUCT LIABILITY LOSSES.**
7 Section 165 of the Internal Revenue Code of 1954
8 (relating to losses) is amended by redesignating subsection

II

1 (i) as (j) and by inserting after subsection (h) the follow-
2 ing new subsection:
3 "(i) SELF-INSURANCE FOR PRODUCT LOSSES AND
4 EXPENSES.—
5 "(1) GENERAL RULE.—In the case of a taxpayer
6 engaged during the taxable year in a trade or business
7 which involves the manufacture, importation, distribu-
8 tion, lease, or sale of a product with respect to which
9 the taxpayer may incur any product liability, at the elec-
10 tion of the taxpayer, there shall be allowed as a deduc-
11 tion under subsection (a) the sum of—
12 "(A) any amounts transferred by the taxpayer
13 for such taxable year to his product liability loss
14 reserve account, and
15 "(B) any amounts paid by the taxpayer for
16 such taxable year to a captive insurer with respect
17 to the product liability of the taxpayer.
18 "(2) DETERMINATION OF AMOUNT.—
19 "(A) TAXPAYER WITH SEVERE PRODUCT LI-
20 ABILITY INSURANCE PROBLEM.—In the case of a
21 taxpayer who has a severe product liability insur-
22 ance problem (as defined in paragraph (11)) for
23 the taxable year, the amount determined under par-
24 agraph (1) shall not exceed the smallest of—
25 "(i) 5 percent of the gross receipts of the

1 taxpayer for such taxable year from the manu-
2 facture, importation, distribution, lease, or sale
3 of such product,
4 "(ii) the amount which, when added to the
5 sum of—
6 "(I) the balance of the taxpayer's
7 product liability loss reserve account, and
8 "(II) the net contributions of the tax-
9 payer to his captive insurer, if any,
10 equals 15 percent of the taxpayer's average
11 yearly gross receipts from the manufacture, im-
12 portation, distribution, or sale of such product
13 during the base period, or
14 "(iii) $100,000.
15 "(B) OTHER TAXPAYERS.—In the case of a
16 taxpayer who does not have a severe product
17 liability insurance problem for the taxable year,
18 the amount determined under paragraph (1) shall
19 not exceed the smallest of—
20 "(i) 2 percent of the gross receipts of the
21 taxpayer for such taxable year from the manu-
22 facture, importation, distribution, lease, or sale
23 of such product,
24 "(ii) the amount which, when added to the
25 sum of—

1 "(I) the balance of the product liabil-
2 ity loss reserve account, and
3 "(II) the net contributions of the tax-
4 payer to his captive insurer, if any,
5 equals 10 percent of the taxpayer's average
6 yearly gross receipts from the manufacture, im-
7 portation, distribution, lease, or sale of such
8 product during the base period, or
9 "(iii) $25,000.
10 "(C) BASE PERIOD.—For the purpose of this
11 paragraph, the term 'base period' means the shorter
12 of—
13 "(i) the period beginning with the most
14 recent preceding taxable year for which the
15 taxpayer elected to have this subsection apply
16 which is immediately preceded by a taxable
17 year for which the taxpayer did not so elect
18 and ending with the current taxable year, or
19 "(ii) the 5-fiscal-year period of the tax-
20 payer which ends with or within the taxable
21 year.
22 "(3) DISALLOWANCE OF DEDUCTION FOR CER-
23 TAIN LOSSES.—In determining the amount of the de-
24 duction allowable for the taxable year under subsection
25 (a) to a taxpayer who has elected to have this sub-

1 section apply, no deduction shall be allowed for any
2 product liability loss paid or incurred by the taxpayer
3 during the taxable year except to the extent that the
4 aggregate amount of such losses during such year exceeds
5 the sum of—

6 "(A) the amount in the product liability loss
7 reserve account of the taxpayer at the beginning
8 of such taxable year, plus

9 "(B) the aggregate amount of payments by the
10 taxpayer to such account within the taxable year
11 which are allowable as a deduction under paragraph
12 (1).

13 "(4) USE OF FUNDS OF ACCOUNT FOR INAPPRO-
14 PRIATE PURPOSE.—

15 "(A) IN GENERAL.—If any amount in a prod-
16 uct liability loss reserve account is, during a taxable
17 year, used for any purpose other than the purpose set
18 forth in paragraph (9) (C) (iii)—

19 "(i) an amount equal to the amount so used
20 shall be included in the taxable income of the
21 taxpayer for the taxable year, and

22 "(ii) the liability of the taxpayer for the
23 tax imposed by this chapter for such taxable
24 year shall be increased by an amount equal to
25 50 percent of the amount so used.

1 "(B) EXCEPTION.—Subparagraph (A) shall
2 not apply to amounts paid out of any product
3 liability loss reserve account not later than the last
4 day prescribed by law (including extensions there-
5 of) for filing the taxpayer's return with respect to
6 the tax imposed by this chapter for the taxable
7 year to the extent the amount of such payment is
8 not more than the excess of—
9 "(i) the aggregate amount of payments by
10 the taxpayer to such account for the taxable
11 year, over
12 "(ii) the maximum amount of such pay-
13 ments which may be deducted under paragraph
14 (2).
15 "(5) TIME WHEN PAYMENTS TO ACCOUNT
16 DEEMED MADE.—For the purposes of this subsection, a
17 taxpayer shall be deemed to have made a payment to
18 his product liability loss reserve account on the last day
19 of the preceding taxable year if the payment is made
20 on account of such taxable year and not later than the
21 last day prescribed by law (including extensions there-
22 of) for filing the taxpayer's return with respect to the
23 tax imposed by this chapter for such taxable year.
24 "(6) PAYMENTS TO ACCOUNT TO BE IN CASH OR
25 CERTAIN OTHER ITEMS.—No deduction shall be allowed

1 under paragraph (1) with respect to any payment to a
2 taxpayer's product liability loss reserve account other
3 than a payment in cash or in items in which the assets
4 in said account may be invested under paragraph (10).
5 "(7) SPECIAL RULE FOR CONTROLLED GROUPS.—
6 "(A) IN GENERAL.—For the purpose of para-
7 graph (2)—
8 "(i) in the case of any taxpayer who,
9 during a calendar year, is a member of a con-
10 trolled group of corporations, only gross re-
11 ceipts properly attributable under section 482
12 to such taxpayer for such year shall be taken
13 into account; and
14 "(ii) the aggregate deductions under this
15 subsection taken by all of the members of a
16 controlled group of corporations for each taxa-
17 ble year shall be limited to the amount that
18 would be permitted under paragraph (2) if
19 all the component members of such group
20 were considered to be a single taxpayer.
21 "(B) DEFINITION OF CONTROLLED GROUP.—
22 For the purpose of subparagraph (A), the term
23 'controlled group of corporations' has the meaning
24 given such term by paragraphs (1), (2), and (3)
25 of subsection (a) of section 1563, except that the

1 determination of whether a taxpayer is a com-
2 ponent member of a controlled group of corporations
3 at any time during a calendar year shall be made
4 on December 31 of such year.

5 "(C) CONTROLLED GROUPS CONTAINING PER-
6 SONS OTHER THAN CORPORATIONS.—Under regula-
7 tions prescribed by the Secretary, principles similar
8 to the principles of subparagraphs (A) and (B)
9 shall be applied to groups of taxpayers under com-
10 mon control where one or more of such taxpayers
11 is not a corporation.

12 "(8) ELECTION OF DISSOLUTION OF ACCOUNT.—

13 "(A) MAKING ELECTION; TERMINATING AC-
14 COUNT.—The Secretary shall prescribe by regu-
15 lations—

16 "(i) the time and manner in which the
17 election under paragraph (1) shall be made
18 by a taxpayer; and

19 "(ii) the time, manner, and conditions un-
20 der which a taxpayer may terminate his
21 product liability loss reserve account, and the
22 funds accumulated therein, if any, may be dis-
23 tributed to the taxpayer without being subject
24 to the penalty described in paragraph (4).

9

1 "(B) SPECIAL REQUIREMENTS.—The regula-
2 tions prescribed by the Secretary regarding the elec-
3 tion under paragraph (1) shall require the taxpayer
4 to indicate whether he is electing to transfer all, or
5 any portion, of the net income earned on amounts
6 previously transferred to his product liability loss
7 reserve account to that account. Net income so
8 earned which the taxpayer does not elect to transfer
9 to his product liability loss reserve account may be
10 withdrawn from that account without penalty under
11 paragraph (4).
12 "(9) DEFINITIONS.—For purposes of this
13 subsection—
14 "(A) PRODUCT LIABILITY.—The term 'prod-
15 uct liability' includes liability for damages arising
16 out of operations after the operation has been com-
17 pleted or abandoned and for damages arising out of
18 physical injuries to persons or property attributable
19 to negligence in, breach of warranty regarding, or
20 defects in a product manufactured, imported, distrib-
21 uted, leased, or sold by the taxpayer.
22 "(B) PRODUCT LIABILITY LOSS.—The term
23 'product liability loss' means any loss attributable
24 to the product liability of the taxpayer.

1 "(C) PRODUCT LIABILITY LOSS RESERVE
2 ACCOUNT.—The term 'product liability loss reserve
3 account' means any trust—
4 "(i) established in writing which is cre-
5 ated or organized under the laws of the United
6 States or of any State (including the District
7 of Columbia) by the taxpayer;
8 "(ii) the trustee of which is a bank (as
9 defined in section 581) or another person
10 (other than the taxpayer or any component
11 member of a controlled group of corporations,
12 within the meaning of paragraph (7), of
13 which the taxpayer is a member) who demon-
14 strates to the satisfaction of the Secretary that
15 the manner in which that other person will ad-
16 minister the trust will be consistent with the
17 purposes for which the trust is established;
18 "(iii) the exclusive purpose of which is
19 to satisfy, in whole or in part, the product
20 liability losses sustained by the taxpayer and
21 the expenses incurred in the investigation, set-
22 tlement, and opposition of any claims for com-
23 pensation against the taxpayer with respect to
24 his product liability, and to pay administrative
25 and other incidental expenses of such trust in

1 connection with the operation of the trust and
2 the processing of claims against the taxpayer;
3 "(iv) the assets of which will not be
4 commingled with any other property other than
5 in a common trust fund and will only be in-
6 vested as permitted in paragraph (10); and
7 "(v) the assets of which may not be bor-
8 rowed, used as security for a loan, or otherwise
9 used by the taxpayer for any purpose other than
10 those described in clause (iii).
11 "(D) CAPTIVE INSURER.—The term 'captive
12 insurer' means any insurer wholly owned or par-
13 tially owned, directly or indirectly, by the taxpayer
14 which is licensed to provide product liability in-
15 surance to the taxpayer under the laws of a State
16 of the United States.
17 "(E) NET CONTRIBUTIONS OF TAXPAYER TO
18 CAPTIVE INSURER.—The term 'net contributions of
19 taxpayer to his captive insurer' means the sum of
20 all premiums paid by the taxpayer to his captive
21 insurer for product liability insurance, less all
22 amounts paid by his captive insurer for claims
23 against the taxpayer for compensation with respect
24 to the product liability of the taxpayer.
25 "(10) RESTRICTIONS ON INVESTMENT OF AS-

1 SETS.—The assets of a product liability loss reserve ac-
2 count may not be invested in anying other than—
3 "(A) public debt securities of the United
4 States,
5 "(B) obligations of a State or local govern-
6 ment which are not in default as to principal or in-
7 terest, or
8 "(C) time or demand deposits in a bank (as
9 defined in section 581) or an insured credit union
10 (as defined in section 101 (6) of the Federal Credit
11 Union Act) located in the United States.
12 "(11) SEVERE PRODUCT LIABILITY INSURANCE
13 PROBLEM.—A taxpayer has a severe product liability in-
14 surance problem for a taxable year if, for such taxable
15 year—
16 "(A) the taxpayer is unable to obtain a pre-
17 mium quotation for product liability insurance, with
18 coverage of up to $1,000,000, from any insurer
19 other than a captive insurer; or
20 "(B) the lowest insurance premium quotation
21 for product liability insurance, with coverage of up
22 to $1,000,000, obtained by the taxpayer was equal
23 to more than 3 percent of the gross receipts of the
24 taxpayer for such taxable year.
25 "(12) DEDUCTIBILITY OF AMOUNTS PAID TO CAP-

35-992 O - 79 - 3

1 TIVE INSURER AS AN ORDINARY AND NECESSARY BUSI-
2 NESS EXPENSE.—The deductibility, in whole or in part,
3 of amounts paid by a taxpayer to a captive insurer for
4 product liability insurance coverage under this subsec-
5 tion shall not affect the deductibility of such amounts
6 under section 162 (relating to ordinary and necessary
7 business expenses), except that such amounts shall not
8 be deducted more than once.

9 "(13) DISCHARGE OF INDEBTEDNESS OF TAX-
10 PAYER BY PRODUCT LIABILITY LOSS RESERVE.—For the
11 purpose of section 61 (relating to gross income), the
12 payment by the trustee of a taxpayer's product liability
13 loss reserve account of product liability losses sustained
14 by the taxpayer, expenses incurred in the investigation,
15 settlement, and opposition of any claims for compensa-
16 tion against the taxpayer with respect to his product
17 liability, or other expenses permitted to be paid by
18 the trustee of such account under paragraph (9), shall
19 not be included in the gross income of the taxpayer.".

20 **SEC. 3. ACCUMULATED EARNINGS TAX.**

21 Section 537(b) of the Internal Revenue Code of 1954
22 (relating to the accumulated earnings tax) is amended by
23 redesignating paragraph (4) as (5) and by inserting after
24 paragraph (3) the following new paragraph:

25 "(4) PRODUCT LIABILITY LOSS RESERVES OR IN-

1 SURANCE.—Amounts accumulated in a taxpayer's prod-
2 uct liability loss reserve account and amounts paid by a
3 taxpayer to his captive insurer for liability insurance
4 shall be treated as amounts accumulated for the reason-
5 ably anticipated needs of the business of the taxpayer
6 to the extent those amounts are deductible under the
7 rules of section 165 (i). Amounts so accumulated or paid
8 which are not deductible are subject to the provisions of
9 this part to the extent that such amounts, when added
10 to the amount deductible under section 165, constitute
11 accumulated taxable income.".

12 SEC. 4. EFFECTIVE DATE.

13 The amendments made by this Act apply to taxable
14 years beginning after December 31, 1977.

95TH CONGRESS
2D SESSION

S. 3176

IN THE SENATE OF THE UNITED STATES

JUNE 7 (legislative day, MAY 17), 1978

Mr. LAXALT introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend section 118 of the Internal Revenue Code of 1954 to clarify the treatment of contributions in aid of construction to regulated electric or gas utilities.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. IN GENERAL.**
4 Section 118(b) of the Internal Revenue Code of 1954
5 (relating to contributions in aid of construction) is amend-
6 ed—
7 (a) by striking out "water" in the portion of para-
8 graph (1) preceding subparagraph (A) thereof and in-
9 serting in lieu thereof "electric energy, gas (through a

II

1 local distribution system or transportation by pipeline),
2 water,";
3 (b) by striking out "water" in paragraph (1) (B)
4 and inserting in lieu thereof "electric energy, gas, steam,
5 water,";
6 (c) by striking out "water" in paragraph (2) (A)
7 (ii) and by inserting in lieu thereof "electric energy,
8 gas, steam, water,";
9 (d) by striking out "property" in paragraph (3)
10 (A) and by inserting in lieu thereof "line" and by strik-
11 ing out "a main water or sewer line" in paragraph (3)
12 (A) and by inserting in lieu thereof "an electric line, a
13 gas main, a steam line, or a main water or sewer line";
14 and
15 (e) by amending paragraph (3) (C) to read as
16 follows:
17 "(C) REGULATED PUBLIC UTILITY.—The term
18 'regulated public utility' has the meaning given such
19 term by section 7701 (a) (33); except that such
20 term shall not include any such utility which is not
21 required to provide electric energy, gas, water, or
22 sewerage disposal services to members of the gen-
23 eral public (including in the case of a gas transmis-

1 sion utility, the provision of gas services by sale for
2 resale to the general public) in its service area.".
3 **SEC. 2. EFFECTIVE DATE.**
4 The amendments made by this Act shall apply to contri-
5 butions made after January 31, 1976.

95TH CONGRESS
2D SESSION

S. 3345

IN THE SENATE OF THE UNITED STATES

JULY 26 (legislative day, MAY 17), 1978

Mr. NELSON introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1954 with respect to the tax treatment of small business investment companies electing to be taxed as regulated investment companies.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. DEFICIENCY DIVIDEND PROCEDURE FOR**
4 **SMALL BUSINESS INVESTMENT COMPANIES**
5 **ELECTING TO BE TAXED AS REGULATED**
6 **INVESTMENT COMPANIES.**
7 (a) IN GENERAL.—
8 (1) Section 852 (relating to the taxation of reg-
9 ulated investment companies and their shareholders) is

II

1 amended by adding at the end thereof the following new
2 subsection:
3 "(e) DEDUCTION FOR DEFICIENCY DIVIDENDS.—
4 "(1) GENERAL RULE.—In the case of a small
5 business investment company licensed under the Small
6 Business Investment Act of 1958 which qualifies and
7 elects to be taxed under this part, if a determination
8 (as defined in subsection (3)) with respect to such
9 company results in any adjustment (as defined in sub-
10 section (2)(A)) for any taxable year, a deduction
11 shall be allowed for the amount of deficiency dividends
12 (as defined in subsection (4)) for purposes of deter-
13 mining the deduction for dividends paid (for purposes
14 of subsection 852(b)(2)(D)) for such year.
15 "(2) RULES FOR APPLICATION OF SUBSECTION
16 (e)(1).—
17 "(A) ADJUSTMENT.—For purposes of this
18 section, the term 'adjustment' means—
19 "(i) any increase in the sum of the regu-
20 lated investment company taxable income of
21 the small business investment company (deter-
22 mined without regard to the deduction for
23 dividends paid (as defined in section 561) and
24 by excluding the excess, if any, of the net long-

1 term capital gain over the net short-term capi-
2 tal loss), and
3 "(ii) any increase in the amount of the
4 excess described in section 852(b)(3) (relat-
5 ing to the excess of the net long-term capital
6 gain over the sum of the net short-term capital
7 loss and the deduction for capital gains divi-
8 dends paid), and
9 "(iii) any decrease in the deduction for
10 dividends paid (as defined in section 561)
11 determined without regard to capital gains
12 dividends.
13 "(B) INTEREST AND ADDITIONS TO TAX DE-
14 TERMINED WITH RESPECT TO THE AMOUNT OF
15 DEFICIENCY DIVIDEND DEDUCTION ALLOWED.—For
16 purposes of determining interest, additions to tax,
17 and additional amounts—
18 "(i) the tax imposed by this chapter (after
19 taking into account the deduction allowed by
20 subsection (e)(1)) on the small business in-
21 vestment company for the taxable year with
22 respect to which the determination is made shall
23 be deemed to be increased by an amount equal

1 to the deduction allowed by subsection (e) (1)
2 with respect to such taxable year,
3 "(ii) the last date prescribed for payment
4 of such increase in tax shall be deemed to have
5 been the last date prescribed for the payment
6 of tax (determined in the manner provided by
7 section 6601 (b)) for the taxable year with
8 respect to which the determination is made,
9 and
10 (iii) such increase in tax shall be deemed
11 to be paid as of the date the claim for the defi-
12 ciency dividend deduction is filed.
13 "(c) CREDIT OR REFUND.—If the allowance of a defi-
14 ciency dividend deduction results in an overpayment of tax
15 for any taxable year, credit or refund with respect to such
16 overpayment shall be made as if on the date of the determina-
17 tion 2 years remained before the expiration of the period of
18 limitation on the filing of claim for refund for the taxable
19 year to which the overpayment relates.
20 "(3) DETERMINATION.—For purposes of this sec-
21 tion, the term 'determination' means—
22 "(A) a decision by the Tax Court, or a judg-
23 ment, decree, or other order by any court of compe-
24 tent jurisdiction, which has become final;

1 "(B) a closing agreement made under section
2 7121; or
3 "(C) under regulations prescribed by the Sec-
4 retary, an agreement signed by the Secretary and
5 by, or on behalf of, the small business investment
6 company relating to the liability of such company
7 for tax.
8 "(4) DEFICIENCY DIVIDENDS.—
9 "(A) DEFINITION.—For purposes of this sec-
10 tion, the term 'deficiency dividends' means a distri-
11 bution of property made by the small business
12 investment company on or after the date of the
13 determination and before filing claim under subsec-
14 tion (5), which would have been includible in the
15 computation of the deduction for dividends paid
16 under section 561 for the taxable year with respect
17 to which the liability for tax resulting from the
18 determination exists, if distributed during such
19 taxable year. No distribution of property shall be
20 considered as deficiency dividends for purposes of
21 subsection unless distributed within 90 days
22 after the determination, and unless a claim for a
23 deficiency dividend deduction with respect to such
24 distribution is filed pursuant to subsection

6

1 "(B) LIMITATIONS.—

2 "(i) ORDINARY DIVIDENDS.—The amount
3 of deficiency dividends (other than deficiency
4 dividends qualifying as capital gain dividends)
5 paid by a small business investment company
6 for the taxable year with respect to which the
7 liability for tax resulting from the determination
8 exists shall not exceed the sum of—

9 "(I) the excess of the amount of in-
10 crease referred to in subparagraph (i) of
11 subsection (2) (A) over the amount of any
12 increase in the deduction for dividends paid
13 (computed without regard to capital gain
14 dividends) for such taxable year which re-
15 sults from such determination, and

16 "(II) the amount of decrease referred
17 to in subparagraph (iii) of subsection (2)
18 (A).

19 "(ii) CAPITAL GAIN DIVIDENDS.—The
20 amount of deficiency dividends qualifying as
21 capital gain dividends paid by a small business
22 investment company for the taxable year with
23 respect to which the liability for tax resulting
24 from the determination exists shall not exceed
25 the amount by which (i) the increase referred

1 to in subparagraph (ii) of subsection (2) (A)
2 exceeds (ii) the amount of any dividends paid
3 during such taxable year which are designated
4 as capital gain dividends after such determina-
5 tion.
6 "(C) EFFECT ON DIVIDENDS PAID DEDUC-
7 TION.—
8 "(i) FOR TAXABLE YEAR IN WHICH
9 PAID.—Deficiency dividends paid in any tax-
10 able year shall not be included in the amount of
11 dividends paid for such year for purposes of
12 computing the dividends paid deduction for
13 such year.
14 "(ii) FOR PRIOR TAXABLE YEAR.—De-
15 ficiency dividends paid in any taxable year shall
16 not be allowed for purposes of section 855 in
17 the computation of dividends paid deduction for
18 the taxable year preceding the taxable year in
19 which paid.
20 "(5) CLAIM REQUIRED. No deficiency dividend
21 deduction shall be allowed under subsection (1) unless
22 (under regulations prescribed by the Secretary) claim
23 therefor is filed within 120 days after the date of the
24 determination.

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1 "(6) SUSPENSION OF STATUTE OF LIMITATIONS
2 AND STAY OF COLLECTION.—
3 "(A) SUSPENSION OF RUNNING OF STAT-
4 UTE.—If the small business investment company
5 files a claim as provided in subsection (5), the
6 running of the statute of limitations provided in
7 section 6501 on the making of assessments, and the
8 bringing of distraint or a proceeding in court for
9 collection, in respect of the deficiency established by
10 a determination under this section, and all interest,
11 additions to tax, additional amounts, or assessable
12 penalties in respect thereof, shall be suspended for
13 a period of 2 years after the date of the determi-
14 nation.
15 "(B) STAY OF COLLECTION.—In the case of
16 any deficiency established by a determination under
17 this section—
18 "(i) the collection of the deficiency, and
19 all interest, additions to tax, additional amounts,
20 and assessable penalties in respect thereof, shall,
21 except in cases of jeopardy, be stayed until the
22 expiration of 120 days after the date of the
23 determination, and
24 "(ii) if claim for a deficiency dividend de-
25 duction is filed under subsection (5), the col-

1 lection of such part of the deficiency as is not
2 reduced by the deduction for deficiency divi-
3 dends provided in subsection (1) shall be
4 stayed until the date the claim is disallowed
5 (in whole or in part), and if disallowed in part
6 collection shall be made only with respect to
7 the part disallowed.
8 No distraint or proceeding in court shall be begun
9 for the collection of an amount the collection of
10 which is stayed under subparagraph (i) or (ii) dur-
11 ing the period for which the collection of such
12 amount is stayed.
13 "(7) DEDUCTION DENIED IN CASE OF FRAUD.—
14 No deficiency deduction shall be allowed under subsec-
15 tion (1) if the determination contains a finding that any
16 part of any deficiency attributable to an adjustment with
17 respect to the taxable year is due to fraud with intent to
18 evade tax or to willful failure to file an income tax
19 return within the time prescribed by law or prescribed
20 by the Secretary in pursuance of law.
21 "(8) PENALTY.—
22 "(i) For assessable penalty with respect to
23 liability for tax of a small business investment com-
24 pany which is allowed a deduction under subsection
25 (1), see section 6697.

1 "(ii) The table of sections for such part I is
2 amended by adding at the end thereof the following
3 new item:

"(e) Deduction for deficiency dividends."

4 **SEC. 2. EFFECTIVE DATE.**

5 The amendments made by section 1 shall apply with
6 respect to determinations (as defined in section 852 (e) (3)
7 of the Internal Revenue Code of 1954) occurring after the
8 date of the enactment of this Act.

Senator BYRD. The committee will come to order. The subcommittee today will consider a group of House and Senate tax bills. I have urged the witnesses to summarize their main points. The full text of their written testimony will be printed in the record as well as the statement of those who are present but who will not be testifying orally.

The subcommittee has prepared a pamphlet describing each of these measures and providing revenue estimates. This pamphlet will be made a part of the record.[1]

The hearings shall begin with a panel of witnesses. Each witness will be limited to 5 minutes. The panel consists of James H. Mack, on behalf of the National Machine Tool Builders' Association, Robert Friedlund, on behalf of the Material Handling Institute, Donald Brotzman, vice president, Rubber Manufacturers Association, Charles W. Stewart, president, Machinery and Allied Products Institute, Walter D. Vinyard, on behalf of the American Insurance Association, Robert Clements, on behalf of the National Association of Insurance Brokers, Anthony Schopp, executive director, Machinery Dealers National Association, on behalf of the Small Business Legislative Council.

This panel will deal with S. 1611 and S. 3049. Gentlemen, who will be the spokesman for the panel?

[Pause.]

Senator BYRD. Who will be the spokesman for the panel? Who will act as chairman?

[Pause.]

Senator BYRD. One of you might as well start. Mr. Mack, will you?

STATEMENT OF JAMES H. MACK, ON BEHALF OF THE NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION, ACCOMPANIED BY JEFF SECREST, VICE PRESIDENT, SECREST MACHINE CO.

Mr. MACK. Good morning. My name is Jim Mack. I am public affairs director of the National Machine Tool Builders' Association. Appearing with me today, Mr. Chairman, is one of your constituents, Jeff Secrest, who is vice president of the Secrest Machine Co., in Alexandria. Mr. Secrest is an example of American business for whom the State placement program did not work.

Mr. Secrest's company, which has been in business for 33 years and has never lost a product liability claim, has been without product liability insurance since June 1977. One-fifth of our members are, like Mr. Secrest, without affordable product liability insurance. Another 20 percent are forced to retain large deductibles. The average premium cost for our members has increased by 1,315 percent since 1970, and for some categories of our smaller members represents an average approaching 3 percent of sales, not including deductibles.

Our written testimony documents the need for congressional action on a broad range of fronts: Tort reform, workers' compensation reform, insurance reform, and the matter before you today, tax reform. If a businessman cannot obtain or not afford adequate product liability coverage—and I would submit that these two terms are synony-

[1] See appendix to this hearing.

35-993 O - 79 - 4

mous—and if he prudently decides to set up a fund to reserve against future product liability losses, present tax law exacts a penalty on his prudence. Moreover, it does not provide equitable tax treatment of expenditures which are clearly and unmistakably business related.

You have two approaches before you to help solve this problem. One is to provide a 10-year carryback for product liability losses, as suggested by the Treasury. The other is to provide tax deductibility for limited contributions to a funded reserve which could be used only for the payment of product liability losses, including defense costs. The carryback provision, standing alone, primarily aids those companies with catastrophic product liability losses which cannot be completely written off over the current 3-year period. It affords no practical relief to a profitable company which has a current but irregularly timed product liability defense and/or settlement costs.

We do not see why each solution must be mutually exclusive. Why not give the businessman the opportunity to prudently reserve against smaller product liability losses with tax deductible dollars—under S. 3049—and to carryback catastrophic losses over a 10-year period—under the administration's proposal? S. 3049 permits companies like Mr. Secrest's to establish a funded product liability reserve account, and, depending upon the severity of his insurance problems, to contribute up to $100,000 annually to the fund.

S. 3049 also precludes the imposition of the excess accumulations tax on these limited funds.

NMTBA believes that the threshold for use of this deferral should be lowered from the 3 percent of sales test contained in S. 3049 and the deduction should not be made available to taxpayers who do not meet this new threshold.

NMTBA is confident that the Finance Committee can devise such a mechanism, and include it as a part of H.R. 13511, along with the 10-year carryback proposal, at a modest first year cost of about $100 million. This committee established a precedent for S. 3049 when, under the leadership of Chairman Long and Senator Hansen, it permitted tax deductible self-insurance reserves for black-lung benefits.

We cannot overstate the immediate need for a product liability tax relief measure which would alleviate the product liability insurance crisis, which is wrecking havoc with the U.S. machine tool industry, and we thank you for this opportunity to present our statement to you.

Senator BYRD. Thank you, Mr. Mack. Senator Packwood?

Senatr PACKWOOD. I want to ask you one question. You indicate that 20 percent of your membership cannot get any kind of product liability insurance?

Mr. MACK. That is correct, sir.

Mr. PACKWOOD. At any price? It is just unavailable?

Mr. MACK. As I indicated, unavailability and unaffordability are for all practical purposes synonymous. Some cannot get it at any price. For most of them, it is a matter of being completely unaffordable.

Senator PACKWOOD. The reason I ask——

Mr. MACK. When you get into the range of 2, 3, 4, 5, 6 percent of sales, it is unaffordable. We have one member who has told us the only insurance that people are willing to sell it to him is priced at 10 percent of sales.

Senator PACKWOOD. The reason I ask is, I think the insurance industry, is going to oppose this, and they are going to argue that it is available, and/or affordable, and if your testimony is that for some people it is simply unobtainable at any price——

Mr. MACK. Yes, sir.

Senator PACKWOOD [continuing]. That is very good rebuttable evidence.

Mr. MACK. Yes.

Senator PACKWOOD. Thank you.

Senator BYRD. Thank you, Mr. Mack. The next witness, Mr. Friedlund, on behalf of Material Handling Institute.

[No response.]

Senator BYRD. Mr. Brotzman?

STATEMENT OF DONALD G. BROTZMAN, VICE PRESIDENT, RUBBER MANUFACTURERS ASSOCIATION

Mr. BROTZMAN. Right here. Thank you, Mr. Chairman.

My name is Don Brotzman. I am the vice president of the Rubber Manufacturers Association. I have had the opportunity of appearing before this committee before, and I would like to join with my colleagues in expressing our gratitude for your having these hearings and bringing this important matter to legislative determination.

The RMA, which I represent—we actually represent about 200 member companies. We produce over 40,000 products, and we are here because we have a problem, too, and our problem, Senator, is the difficulty our membership has in getting product liability insurance and the economic disability of having our insurance rates going up about 400 percent during the last 4 to 5 years. Some would be more than that, some slightly less, but for a mean average it would be about 400 percent.

We are trying to deal with the problem on three fronts. First of all, on a long-range basis, we believe there must be tort reform, because we know this is the genesis of the problem throughout the States, and we have a program at the State level. No. 2, we are trying to spread the risk or go through a risk management program so that we can have joint industry action in this regard, but third and, I think, as important or even more so, is to have the U.S. Congress grant some sort of a framework that will enable us to insure ourselves in certain respects. My industry comes down strongly for the principle of having a deduction, a tax deduction for contributions to a trust to permit us to insure ourselves.

We realize that there have to be safeguards built therein. We want it to be fair to industry, and we want it to be fair to the Government. We know that we should not be able to put money away in the trust for other purposes. The money should be used for product liability self-insurance. We have studied most of the legislation available on this subject and we find a variety of approaches, including those by Senator Culver which have certain protections in this regard.

We also would say this—that if the committee does determine that we should go the self-insurance route with a tax-exempt trust, we hope it is not going to be so complex and burdensome that we cannot make

it work, because we have seen examples of penalty excise taxes imposed upon other trusts. So we would regret that there must be flexibility, to permit the trust to function and to permit us to meet our responsibilities.

Finally, we feel that there is an urgency to the problem, and we trust that this session of Congress will be able to deal with this isseu. Thank you.

Senator BYRD. Senator Packwood?

Senator PACKWOOD. How is the trust that you are going to set up stop any lawsuits, stop any loss ratios or anything else that now exists when you insure through insurance companies?

Mr. BROTZMAN. It will not actually stop any of the lawsuits. That is correct. That would have to go back to the tort reform propositions I mentioned at the State level. It will not stop it. It will help us to cover economically, more economically that area of the loss we simply cannot do right now.

Senator PACKWOOD. That is what I do not understand. Your insurance premiums are deductible. Assuming the insurance companies are not just ripping you off and are doing nothing but trying to cover the cost of their losses plus a reasonable profit, why is this any cheaper?

Mr. BROTZMAN. That is precisely the point, and I understand your question. We think that there is not a valid relationship between the amount of premiums that we pay and the losses that we are sustaining. In other words, we think there is an exorbitant increase in the amount of premiums required, in relation to our losses.

Senator PACKWOOD. Do you think this is true of your industry or do you think that generally all industries are not sustaining and the insurance industry is making a whopping profit? Where is the money going, if all of the industries are not bearing losses in relation to the premiums they are paying, and the insurance companies are not making an exorbitant profit? Where is the money going?

Mr. BROTZMAN. I am not going to make a lot of allegations relative to where the money is going, because I do not really know, and I cannot speak for any other industry, but I can tell you that I have talked to many others who are having a problem similar to ours. They express the same concern, the same requirement, a need for some kind of legislative action. Where the money goes is something the committee would probably have to find out, Senator.

Senator PACKWOOD. The reason I ask is because I can see down the road what will happen. You will start on this, reserves will not be big enough, some companies will not be able to afford it, and you will end up with a products liability ERISA, with the Federal Government managing your funds, and in retrospect you would probably wish you had never gotten into it.

Mr. MACK. Senator, could I respond to your question? May I?

Senator PACKWOOD. Yes.

Mr. MACK. Our testimony documents our claims experience. About 12 percent of the claims against our members actually go to trial. We win 75 percent of them, which means that 3 percent of the claims that are brought against our members result in a plaintiff receiving an amount of money in the courtroom which is substantially in excess of the worker's compensation lien. However, for every dollar the in-

surance companies pay out, they pay out another 35 cents in defense costs.

Senator PACKWOOD. Won't you have to do the same thing?

Mr. MACK. Yes, sir, but I think it is fair to say that based upon what has happened to our industry over the last 8 years and based upon the evidence accumulated by the interagency task force on product liability, there has been some substantial panic pricing on the part of the insurance industry. They basically sort of expect the worst and hope to be surprised, to use the term of the California Tort Commission. The cost of insurance has become completely unaffordable for many of our members.

Senator PACKWOOD. Do you have any rating experience in the industry on premiums? You have good records. Do your premiums go down like workmen's compensation with a good safety record?

Mr. MACK. Senator, there are members of ours like Mr. Secrest who cannot afford insurance and whose suggested premium had gone up substantially. The average increase for those in our industry who have insurance is 1,315 percent. Many of these companies have no claims.

Senator PACKWOOD. My question is this, is there any experience rating between employers in this business?

Mr. MACK. You would have to ask that of the insurance industry. I am told that there is some, but it appears to us that there is no relationship whatsoever between the premiums that are being charged or being suggested to some of our members and their experience, many of whom have had no claims at all and most of whom have never lost a claim.

Senator BYRD. Thank you, Mr. Brotzman. Charles W. Stewart, president, Machinery and Allied Products Institute.

STATEMENT OF CHARLES W. STEWART, PRESIDENT, MACHINERY AND ALLIED PRODUCTS INSTITUTE, ACCOMPANIED BY CHARLES I. DERR

Mr. STEWART. Thank you, Mr. Chairman.

In accordance with the rules and in view of the fact that you have admitted the institute's statement to the record, I will be very brief.

I would like to comment for a moment about Senator Packwood's questions. You will, of course, hear from the insurance industry today, and I guess they are best able to indicate how they rationalize their premiums. We have a feeling that the rationalization is a little thin or nonexistent, but on the other hand I certainly would defer to them to some extent in terms of their answer. With regard to the question of insurance availability, we should bear in mind that for many companies a very high and unacceptable deductible is involved, so that the insurance, even when granted, carries a deductible as to which the company has to self-insure, whether you have the proposed type of relief or not.

Let me just tick off two or three points and then refer you to our statement. If the record would not be burdened too much, we would like to have included as a part of our presentation results of a survey in August 1976.

Senator BYRD. Without objection, it will be a part of the record.

[The material referred to follows:]

Products Liability: A MAPI Survey

Foreword

Few problems confronting American industry have grown as swiftly as products liability. For a considerable number of companies this phenomenon has now reached a crisis stage.

The interest of the Machinery and Allied Products Institute in products liability dates back some 15 years and originated with the work of the Institute's Insurance Council. Our work in the field, encouraged by the MAPI Executive Committee, has included the continuing and enlarging attention of the Insurance Council, the publication of two full-length books--Products Liability and Reliability: Some Management Considerations (1967) and Company Programs To Reduce Products Liability Hazards (1972)--and a series of memorandums on the subject, frequent consultation with member companies, and, most recently, creation of a MAPI Products Liability Council. I think it is fair to say that no business organization has devoted more attention, research, and documentation to this subject than has MAPI.

Some months ago, in accordance with discussions with the MAPI Executive Committee, the Institute staff undertook the identification and development in some detail of possible alternative approaches to solution of the problem. In considering how best to embark upon this search, we enlisted the aid of certain members of the Insurance Council and the Products Liability Council who were--and are--possessed of unusual experience and expertise in the field. They agreed unanimously that an appropriate starting point for this quest would be a comprehensive survey of member company experience and attitudes respecting products liability.

A comprehensive MAPI questionnaire on this subject, developed with the aid of those member company executives who first suggested a survey, was transmitted to Institute member companies on March 4, 1976 and followed up late in April. This memorandum is devoted to a full report of the survey.

On behalf of MAPI, I want to express our keen sense of appreciation to all those member companies who completed and returned the long, detailed, and complicated questionnaire and especially to those member company executives who were so very helpful in the questionnaire's development. We hope that the full report which follows, by providing a badly needed data base, may prove of some assistance in the ultimate solution of the increasingly serious problem of products liability as a part of MAPI's continued and intensive work on the subject.

Charles W. Stewart
President

August 1976

Introduction

As detailed more fully in the report itself, the MAPI survey on products liability produced 210 responses across a broad range of industry with by far the greatest concentration in the capital goods industries. Given the size and the representativeness of the sample of companies responding to the MAPI questionnaire, we know of no other survey of products liability of comparable size or comprehensiveness. Moreover, with both the Congress and the Administration actively studying the products liability phenomenon, it seems to us that the release of survey results is most timely and a part of an essential prerequisite to designing a solution or solutions.

Certain difficulties were foreseen by those member company executives who assisted in the preparation of the questionnaire. It was suggested, for example, that--save for casualty insurance company reserves--there is no standard and accepted method of recording data pertinent to products liability claims. In whatever form such data is maintained, moreover, it will be retained for varying periods of time by individual companies. Again, it was pointed out, the greatly differing arrangements by which companies insure against the products liability hazard--differences occasioned by company size and product line--might well produce noncomparable data. And as for suggested solutions, it was noted that any ideal solution or solutions--if such exist--face the uncertain hazards of legislative and judicial action. In some measure, all these difficulties--and others--were evidenced in the course of the survey. We do not believe they have impaired the survey's usefulness. Indeed, by helping to illuminate the breadth and depth of the problem, its extraordinary complexity and its rather obvious resistance to any easy solution, they may well have made a positive contribution.

The results of this survey of company experience with products liability contain few surprises for people who have lived with the problem over the years of its rapid growth. For the most part it supports and extends projections made from lesser bodies of data--although it is considerably broader in scope and deeper in sample of respondents than most earlier surveys--it verifies preexisting suppositions, and it confirms intuitive conclusions with objective fact. In addition it will provide, we believe, a new and broader perspective and, one hopes, some new understanding of a problem of surpassing complexity. For those interested in the subject a careful reading of the full report is recommended. However, because the full report is a long one and by way of an introduction and overview, we have summarized the survey's main findings below.

Highlights

The highlights of the full report are summarized below.

-- Some 210 MAPI member companies, representing a broad cross-section of industry, participated in the MAPI survey.

-- The experience of respondents indicates a sharp rise in both the number and amount of products liability claims over the past decade.

-- For the period 1965 through 1975, 156 companies reported products liability suits filed against them in the amount of $826 million by plaintiffs' estimates; at the end of this period, 162 companies reported suits pending of $259 million with this figure based not on plaintiffs' evaluations but on amounts reserved against such claims by insurance carriers.

-- The majority of respondents have attacked the products liability problem by assigning special responsibility therefore to an individual or a committee; most such individuals or committees report to general management either at corporate or divisional level.

-- Almost all respondent companies carry primary products liability insurance coverage; a slightly higher percentage carry excess products liability coverage. The majority of respondents consider insurance coverage adequate, but nearly half consider the cost unreasonable.

-- More than 94 percent of those companies which answered the question indicated that their products liability premium rates had increased over the past five years, in addition, more than one-third of these companies were required to accept a deductible of a large retrospective retention. In percentage terms, the premium rate increase ranged from 0 to more than 4,000 percent with some 58 percent of the companies responding to this question reporting increases between 100 percent and 1,000 percent.

-- A significant minority of responding companies (16 percent) believe that the upsurge in products liability claims has inhibited the development of new products or contributed to the discontinuance of existing products.

-- Less than 10 percent of respondent companies believe that products liability can be solved without legislation. Of those who believe legislation is necessary, the great majority think federal or federal and state legislation is necessary.

-- The more important of respondents' suggestions for solving the products liability problem in descending order of popularity include the following:

(1) Eliminate contingent lawyers' fees.

(2) Make employer responsible where a work-related injury is caused by his negligence.

(3) Enact statutes of limitation concerning products liability which would restrict liability to a specified time period, limit liability to ownership by original purchaser, and free the manufacturer of liability where product has been altered or misused.

(4) Limit the amount of awards in products liability cases for damages other than medical and hospital expenses.

(5) Make workmen's compensation the sole remedy for a work-related injury.

(6) Improve product quality.

(7) Apportion fault between manufacturer and employer and other defendants in a work-related injury.

(8) Limit or eliminate altogether the doctrine of strict liability.

In concluding this introduction to the MAPI survey of products liability, it seems necessary to reemphasize the complexity of the problem and the elusiveness of any final solution. As in the fable of the blind men and the elephant, it is very possible to see products liability as a legal problem, or an engineering problem or a manufacturing problem or a marketing problem--or whatever kind of problem it is that an individual's personal blinders permit him to see. Products liability is, of course, each of these things. It is also all of them and therein lies the difficulty of solution and the improbability of clearing up the products liability mess by a single stroke, however inspired.

Just as the blind men, one by one, described the elephant according to what it was that each was able to feel of this strange creature so do approaches to the solution of products liability differ

according to the individual's vision of the problem. A good sized group holds that legislation is indispensable to the solution, some look to the courts, others insist that better products are the principal, if not the sole, solution. One important element of any final solution is already in being and takes the form of individual company programs to eliminate or mitigate the products liability hazard. Still others preach--and practice--the doctrine of vigorous and unyielding defense of products claims. One can only say--with some confidence--that there is no one solution to the burgeoning problem of products liability, a conclusion which seems fully borne out by the results of the MAPI survey.

Breakdown of Companies By Product Line and Size

Product Line Representation

Principal Product Line(s). Please identify by 3-digit Standard Industrial Classification (SIC) Code, 1967 Manual.

A total of 210 companies out of 4[illegible] surveyed took part in the survey. Respondents were asked to identify "principal product lines" by 3-digit Standard Industrial Classification (SIC) Codes. Activity in some 9[illegible] such codes, concentrated principally in "Manufacturing" but with limited representation in "Mining," "Construction," "Transportation and Public Utilities," "Wholesale Trade," "Retail Trade," "Finance, Insurance and Real Estate" and "Services" was reported by survey participants. Within these general classifications, 6[illegible] "principal product lines"—or an average of slightly less than three for each of the respondent companies—were represented in the survey.

To give some measure of the survey's scope, shown below by SIC code number and title are the numbers of principal individual product lines represented in the survey:

3-digit SIC Code No.	Title	Number of Respondents
331	Blast Furnaces, Steel Works, and Rolling and Finishing Mills	[illegible]
332	Iron and Steel Foundries	16
336	Nonferrous Foundries (Castings	11
342	Cutlery, Hand Tools, and General Hardware	10
346	Iron and Steel Forgings	10
349	Miscellaneous Fabricated Metal Products	30
351	Engines and Turbines	7
352	Farm and Garden Machinery and Equipment	6
353	Construction, Mining, and Materials Handling Machinery and Equipment	59
354	Metalworking Machinery and Equipment	59
355	Special Industry Machinery, Except Metalworking Machinery	53
356	General Industrial Machinery and Equipment	62
357	Office, Computing, and Accounting Machines	9
358	Refrigeration and Service Industry Machinery	16

3-digit SIC Code No.	Title	Number of Respondents
359	Miscellaneous Machinery, Except Electrical	7
361	Electric Transmission and Distribution Equipment	5
362	Electrical Industrial Apparatus	17
363	Household Appliances	4
364	Electric Lighting and Wiring Equipment	6
366	Communication Equipment	9
367	Electronic Components and Accessories	14
371	Motor Vehicles and Motor Vehicle Equipment	19
372	Aircraft and Parts	14
373	Ship and Boat Building and Repairing	3
374	Railroad Equipment	5
381	Engineering, Laboratory, Scientific and Research Instruments and Associated Equipment	5
382	Measuring and Controlling Instruments	14

Company Size

Sales volume (please check one)

Volume of Sales	Number of Respondents
Under $10 million	25
$10 million - $50 million	53
$50 million - $100 million	29
$100 million - $500 million	59
$500 million - $1 billion	18
$1 billion and over	26
	210

I THE ANATOMY OF THE PROBLEM

Industrial Products vs. Consumer Products

	Yes	*No*
A. *Is your company's output limited primarily to industrial products?* (210)/1	191	19

1/ The figures immediately following the questions indicate the number of tabulated replies.

	Range
8. *If your company manufactures consumer goods, would you please indicate roughly what percentage they represent of total sales.* ________ %	9% to 95% /1

How Serious Is the Problem?

	Yes	No
1. *Does your company have a products liability "problem"? If so, how would you describe it. (Please check one)* (205)	183	22

	Number of Respondents
serious	38
potentially serious	96
costly, but not of great magnitude	36
de minimis	13
	183

II PRODUCTS LIABILITY CLAIMS EXPERIENCE

A. *Total claims paid and reserved for years identified*

1. *number of claims and (2) dollar value*

The years "identified" were 1965, 1970, 1973, and 1975. As to each the respondent was asked to indicate both the number and dollar value of claims paid and reserved. The results follow with the number of companies responding to each question shown parenthetically after the answer.

	number	*dollar value*	
1965	6,641	$11,[illegible]	(159)
1970	7,034	[illegible]	(192)
1973	11,182	76,250,15[illegible]	(193)
1975	9,365	81,236,2[illegible]	(191)

The abrupt increase in amount of claims from 1965 to 1970 and beyond is accounted for in part, but only in part, by the disparity in numbers of companies reporting in the first of these years versus the last three. That difference, incidentally, is accounted for by the fact that a substantial number of respondents no longer have 1965 claims records. Notwithstanding this difference, a clear pattern of increase is shown in the dollar amount of claims paid and reserved by reporting companies over the period from which these years were selected. As for the number of such claims, the pattern of increase would appear to have been interrupted in 1975 for which some 1,300 fewer claims were reported than for the next earlier year of 1973. The appearance is an illusion, a false dawn. The

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1/ Only 15 respondents or 7 percent of the total reported consumer goods sales of 20 percent or higher.

fact is that the 1975 figures reported--and to a lesser extent the 1973 figures--are preliminary only; more--and probably considerably more--claims assignable to 1975 will be reported in the future. A typical comment on the point says, "Many claims are not reported to us until two to four years have elapsed from the date of accident; this is particularly true of those claims involving industrial products. These claims have also been the company's largest claims."

To consider these figures from another standpoint, the average claim in 1965 was $1,730; in 1970 it was $7,258; in 1973 it was $6,819; and in 1975 it was $8,234. Thus, although the averages do not represent an unbroken pattern of increase the trend line is clearly upward.

(3) *Size of claims* (184)

	Number of Claims Paid and Reserved			
	1965	*1970*	*1973*	*1975*
under $1,000	4,285	4,181	4,492	2,584
$1,000 - $10,000	906	1,476	1,898	1,291
$10,000 - $100,000	195	530	849	492
$100,000 - $500,000	19	64	169	90
$500,000 - $1 million	2	11	15	41
over $1 million	0	4	17	11

Again, the trend in products liability claims over the period is clear and, consistent with our observations above, the figures reported for 1975 must be considered preliminary. Two comments of respondents deserve repeating. One says in respect to the pattern of claim activity, "The number of lawsuits filed against the _____ company in the product liability area increased from slightly over 100 lawsuits in 1965 to over 1,200 lawsuits in 1975." Another, quoting the "Cook County Jury Verdict Reporter" and addressing the size-of-claim matter on a comparative basis says, "Our Cook County court system here in Chicago recently compiled figures for a one-year period extending from September 1, 1974 through and including September 1, 1975. Such compilation of statistics reflected that $6.7 million was awarded to traffic collision litigants involving 225 collisions whereas $6.9 million was awarded in 18 cases of product liability litigation. In other words, there was an average award in Cook County last year in product liability litigation of $383,000 per case."

An analysis of the rise in the amount of claims over the period covered reveals some interesting numbers. Excluding 1975 figures for reasons already indicated, consider what has happened over the period 1965 to 1973 within the dollar brackets on which responses were classified. Claims under $1,000 (many of them doubtless "nuisance" claims) have remained at substantially the same level. But claims in the $1,000-$10,000 bracket rose from 906 to 1,898, or 109 percent; claims in the $10,000 to $100,000 bracket rose from 195 to 849, or 335 percent; claims from $100,000 to $500,000 rose from 19 to 169, or 789 percent; claims from $500,000 to $1 million rose from 2 to 15, or 750 percent; and claims over $1 million rose from 0 to 17, or by an infinite percentage. No doubt some part of this is inflation, but that alone cannot explain these phenomenal percentage increases.

B. *Claims data for the period 1970-75*

This question, subdivided into nine parts, sought both to summarize and analyze total claims data for the respondent company over the period 1970-75. Either because the data was not available at all or, if available, was not readily translatable into the form requested, some companies did not answer the question. Moreover, not every company which did respond answered every part of the question. The summary of responses, classified in accordance with the question's several parts and with the number of responses to each part of the question shown parenthetically, appears below.

		Number of Claims [illegible]	Amount of Claims	
(1)	Total claims presented [illegible]	[illegible]	[illegible]	[illegible]
(2)	Claims paid [illegible]	[illegible]	[illegible]	[illegible]
(3)	Claims rejected by your company 1/	[illegible]	[illegible]	[illegible]
(4)	Claims pending	[illegible]	[illegible]	[illegible]
(5)	Suits filed on claims against your company	[illegible]	[illegible]	[illegible] 2/
(6)	Judgments for claimants	[illegible]	[illegible]	[illegible]
(7)	Suits settled out of court	[illegible]	[illegible]	[illegible]
(8)	Judgments for your company 3/	[illegible]	[illegible]	[illegible]
(9)	Suits pending	[illegible]	[illegible]	[illegible]

These are impressive figures. The enormous sums shown as "total claims presented" and "suits filed" represent in most cases the plaintiffs' demands and hence include a goodly measure of blue sky. However, the amount shown for "suits pending" represents not the plaintiffs' demands--or dreams--but the sum of established insurance company reserves or the company's best estimate of what the total of products liability suits against it are actually

1/ Many respondents simply indicated the number of claims rejected and showed no amount for such claims. Thus, the "Amount of Claims" in this case is derived from only 892 of the total of rejected claims reported.

2/ Some 34 percent of this total is attributable to one company.

3/ Here again many respondents reported judgments for the company without specifying the amount of claims involved. In fact, the amount of claims thus disposed of involves only 197 actual claims.

worth. The figure, incidentally, was checked directly in most cases with any company whose answer left any question on the point. In a few remaining questionable cases where it was impossible to verify the figures with companies involved, sums which were rather obviously the total of plaintiffs' demands were arbitrarily deflated on a ratio of 1 to 10.

As originally conceived, the 9 parts of this question were supposed to represent this equation: (1) - (2) through (8) = (9). However, the framers of the question did not reckon with the creativity of respondents who did not consider a lawsuit first brought to their attention as a "claim presented." Thus the balance intended to be struck is not achieved.

C. Products liability claims first presented during 1975 by type of claimant and class of product

This question comes at claims data from still another direction. It seeks to determine for the most recent complete year the comparative importance of three general sources of products liability claims: (1) employees of other companies; (2) members of the general public; and (3) insurance companies via subrogation. Typically, products liability claims involving capital goods are work-related. They frequently involve a suit against a machinery manufacturer by an employee of the manufacturer's customer who is injured on the job and alleges that the manufacturer's product was at fault. Thus, one may infer that most if not all claims arising under this classification are "capital goods cases." Moreover, employees injured on the job are compensated by workmen's compensation and where in the usual case such benefits are paid by an insurance carrier, the latter is subrogated--to the extent of benefits paid--to any rights the injured employee may have against a machinery manufacturer. This is, of course, situation (3) above.

As for the second of these categories of products liability claims, those by members of the general public, the majority of such claims are against manufacturers of consumer goods whose products are sold directly to, and are used by, members of the general public. A lesser, although still substantial, number of such claims may involve capital goods which come into contact with the general public (e.g., transportation equipment, construction equipment, etc.).

The summary of survey responses to this question appears below.

Claims by employees of other companies.--In this case, as in the case of responses to all three subparts of this question, more companies reported claims falling in this category than reported dollar amounts of such claims. A total of 1,385 claims from this source was reported by 187 participating companies. Only 164 of these companies reported dollar amounts of such claims amounting to $128,504,425.

There were 80 4-digit SIC product codes represented here with the vast majority in the following 2-digit SIC codes: 34--Fabricated Metal Products, Except Machinery and Transport Equipment; 35--Machinery, Except

Electrical; 36--Electrical and Electronic Machinery, Equipment and Supplies; and 37--Transportation Equipment. Among the specific 4-digit SIC codes showing the greatest activity (and it must be remembered that this question was limited to "Products liability claims first presented in 1975") were: 3531--Construction Machinery and Equipment (15); 3535--Conveyors and Conveying Equipment (7); 3536--Hoists, Industrial Cranes and Monorail Systems (6); 3537--Industrial Trucks, Tractors and Stackers (4); 3541--Machine Tools, Metal Cutting Types (11); 3542--Machine Tools, Metal Forming Types (6); 3559--Special Industry Machinery, Not Elsewhere Classified (7); and 3568--Mechanical Power Transmission Equipment, Not Elsewhere Classified ([illegible]).

<u>Claims by members of the general public</u>.--There were a total of 1,[illegible] products liability claims falling in this category reported by 160 companies. Only 1[illegible] of these companies reported the amounts of such claims, the total of which is $176,068,66[illegible]. (It should be noted, however, that this figure would be reduced to $79,78[illegible],0[illegible], if claims against [illegible] reporting companies whose sales are 20 percent or more in consumer goods were eliminated from the total.)

Respondents reported claims involving products in 72 4-digit SIC product codes. Those with the heaviest representation included: [illegible]--Fabricated Plate Work (Boiler Shops) ([illegible]); 3531--Construction Machinery and Equipment (11); [illegible]--Electric Housewares and Fans ([illegible]); 371[illegible]--Motor Vehicles Parts and Accessories ([illegible]); and 382[illegible]--Industrial Instruments (etc.) ([illegible]).

<u>Claims by insurance companies</u>.--There were 1[illegible] responses to this question covering 229 claims. Of this number of participating companies, 1[illegible] reported claims totaling $1,[illegible],651. The great disparity in amounts between those reported here and those involving claims by employees of other companies and members of the general public is accounted for by the fact that any subrogation claim is limited to the amount of workmen's compensation benefits paid and includes no claims for pain and suffering, loss of consortium, etc. Moreover, a number of claims were reported as to which respondents indicated "no amount yet stated."

Responses to the last of the three categories into which respondents were asked to put products liability claims first presented during 1975 involve 53 different 4-digit SIC product codes. Inasmuch as claims by insurance companies via subrogation originate in on-the-job injuries which lead to allegations of faulty design or manufacture of some product used in the workplace, one may properly assume that such claims will be concentrated in the capital goods area. The summary of responses to this question bears out that assumption. Although claims classified in this category extend across the whole range of machinery and equipment and allied industrial products, the greatest number of reported claims were in the following: 3494--Valves and Pipe Fittings, Except Plumbers' Brass Goods (3); 3531--Construction Machinery and Equipment (5); 3536--Hoists, Industrial Cranes and Monorail Systems (5); 3541--Machine Tools, Metal Cutting Types (5); and 3559--Special Industry Machinery, Not Elsewhere Classified (5).

D. *How many products liability suits and/or claims does your company now have pending?*

There were 191 responses to this question and 15,131 suits and/or claims now pending were reported. This amounts to somewhat more than 79 suits and/or claims for each of these 191 companies.

III ORGANIZING TO DEAL WITH THE PROBLEM

		Yes	No
A.	*Does your company have any individual(s) or committee having special responsibility for products liability?* (208)	164	44

B. *Where are they located?*

Almost 80 percent responded affirmatively, a statistic which rather clearly indicates the widespread concern in industry with the problem of products liability.

As for location, 117 companies have such an individual or committee at headquarters with this total subdivided as follows: committee--38; individual--79.

Of those companies who responded affirmatively to the first question, 47 indicated placement of such an individual or committee at division or subsidiary level. Here the preference is for the committee approach with 28 favoring that and 19 having an individual perform the job.

A total of 50 respondents indicated coverage at both corporate and division levels.

C. *To whom (title only) does any such individual or committee report?*

A total of 142 companies answered this question with 113 indicating the reporting line at headquarters and 29 at division or subsidiary level. Some companies, as we have seen, have such organizational arrangements at both locations.

Of the 113 replies pertaining to corporate headquarters, the summary of executives to whom any such individual or committee reports breaks down as follows:

Title	Number of Respondents
President	32
Vice President (including those with and without special titles such as "VP-Engineering")	27
Senior Vice President	7
Executive Vice President	6
Secretary (including some who are General Counsel)	5

Title	Number of Respondents
Treasurer	[illegible]
Chairman	[illegible]
Chief Executive Officer	[illegible]
Group Vice President	[illegible]
General Counsel	[illegible]
Counsel	[illegible]
"Top Management"	[illegible]
Director of Insurance and Safety	[illegible]
Director of Product Integrity (or Product Assurance)	[illegible]
General Manager	[illegible]
Assistant Treasurer	[illegible]
Assistant to the President	[illegible]
General Counsel and Treasurer	[illegible]
Assistant Controller	[illegible]
"Senior Corporate Manager"	[illegible]
Director of Research and Development	[illegible]
Director of Financial Staff	[illegible]
Director of Engineering Staff	[illegible]
Director of Risk Management	[illegible]
Product Liability Coordinator	[illegible]
	[illegible]

As is obvious from this array, in the vast majority of cases the reporting line for any individual or committee at corporate headquarters charged specifically with responsibility for product liability runs directly to a member of senior management. This would appear to evidence top management's commitment to the problem's solution.

The pattern is the same at division or subsidiary level. Responses break down as follows:

Title	Number of Respondents
Division President (including "CEO")	[illegible]
Vice President	[illegible]
Division (Subsidiary) Manager	[illegible]
Group Vice President	2
"Division Head"	2
Senior Vice President	1
Group Manager	1
Division Controller	1
Director of Engineering	1
Product Safety Manager	1
"Varies by location"	1
	29

D. If a committee has responsibility, what corporate functions are represented?

There were 93 companies which responded to this question. Among these companies are representation on such committees of management functions identified in the question as follows:

Function	Number of Respondents
Engineering	82
Manufacturing (quality control)	74
Risk Management/Insurance	68
Design	65
Law	60
Research and Development	58
Safety	55
Marketing	54
Advertising	41
Purchasing	28
Industrial Relations	17

Beyond those functions listed in the questionnaire, comments of respondents indicated representation on such committees of other management responsibilities including: Service, Parts Department, Product Support, Chief Administrative Officer, Training, Finance, Environmental Engineering, Toxicology, and Industrial Hygiene.

E. If a committee structure, who acts as chairman? (Title only) As executive director? (Title only)

Chairman.--Some 77 companies responded to the first of these two questions. Their responses reveal a remarkable diversity of approach to the chairmanship of any corporate or division committee with special responsibilities for products liability. As indicated by the subdivision of the summary of responses which appears below, 25 of these 77 companies have appointed a member of general management as chairman and 22 have entrusted the post to an engineering executive. Of the remainder, distributed largely on a functional basis, 9 quality control executives chair such committees as do 7 marketing and customer service executives and 5 risk (insurance) managers.

Chairman of "Products Liability" Committee	Number of Respondents
General Management	
President	8
Senior Vice President	3
Group Vice President	1
Vice President	6
Treasurer	5
Secretary	3
	26

	Number of Respondents
Engineering	
Vice President - Engineering	[illegible]
Vice President - Technical Director	[illegible]
Chief Engineer	[illegible]
Manager of Engineering	[illegible]
Manager, Engineering Standards	[illegible]
Director of Engineering Analysis	[illegible]
Field Engineering Manager	[illegible]
	12
Marketing and Service	
Vice President, Marketing	[illegible]
Vice President, Consumer Affairs	[illegible]
General Sales Manager	[illegible]
Director of Consumer Affairs	[illegible]
Director of Customer Service and Quality Assurance	[illegible]
General Manager, Service Operations	[illegible]
	[illegible]
Quality Control	
Manager of Product Quality	[illegible]
Manager of Product Safety	[illegible]
Product Safety Engineer	[illegible]
Product Safety Coordinator	[illegible]
	[illegible]
Safety and Health	
Director, Occupational Health and Safety	[illegible]
Safety Engineer	[illegible]
	2
Law and Insurance	
General Counsel	1
Risk (Insurance) Manager	5
Attorney	1
	7
Miscellaneous	
Director of Planning	1
Products Liability Coordinator	1
Assistant to the President	1
Assistant to General Manager	1
	4

Executive Director.--A considerable lesser number of companies--35--answered the query concerning the executive director of any "products liability committee" than answered the preceding question on the chairmanship. As will appear from the summary of responses below, one may infer that the question was not completely understood and that there was at least some confusion between the function of organizing and directing the affairs of any such committee and the managerial post to which the committee reports. Notwithstanding the relative paucity of response to this question, one further--and important--inference is at least suggested. Adding the total of senior executives--10--represented to be "Executive Directors" (and one doubts if they are in fact preparers of agendas and carriers of paper on committee matters) to that number of responses--8--indicating that there is "none" [i.e., Executive Director], the result is 18 or more than half those companies which answered this question. From this, one could conclude that some such committees have an occasional or ad hoc rather than a continuing existence because an "Executive Director" devoting all or most of his time to committee affairs would seem to be essential to a continuing committee life. Although it is not clear from answers to the question, it must be concluded that the function of "Executive Director" may be performed without that title or any title being assigned.

Executive Director of "Products Liability Committee"	Number of Respondents
General Management	
President	4
Executive Vice President	3
Vice President - Operations	1
Division President	1
Division General Manager	1
	10
Research, Development and Engineering	
Vice President, Research and Development	1
Director of Research, Development and Engineering	1
Plant Engineer	1
	3
Quality Control	
Manager, Product Safety	2
Product Safety Engineer	1
Division Manager - Product Integrity	1
	4
Miscellaneous	
Vice President, Corporate Development	1
Controller	1
Insurance Counsel	1
"Industrial Relations"	1
"Same" (i.e., same as Chairman)	6
"None"	8
	18

(1) *does either devote full or substantial time to this function?* (87) — *Yes* 28, *No* 59

If so, which one? (14)

<u>Full-time to committee function</u>.--This question was concerned with whether or not any "products liability committee" has a day-to-day existence which would seem most likely only if someone devoted all or a substantial part of his time to the affairs of the committee. Of 87 responses to the first question, 28 said "Yes" and 59 said "No." There were only 14 responses to the second question, of which 3 indicated that, respectively, the chairman, the president and the corporate secretary devoted "full or substantial time to this function." One doubts it. The remaining responses, as summarized below, seem more likely to represent situations in which full or substantial time is so devoted.

	Number of Respondents
<u>Senior Executives</u>	
Chairman	1
President	1
Secretary	1
	3
<u>Quality Control and Engineering</u>	
Manager of Product Safety	1
Director of Engineering Analysis	1
Chief Industrial Engineer	1
Safety Engineer	1
	4
<u>Law and Insurance</u>	
Corporate Risk Manager	1
Director of Safety and Insurance	1
Attorney	1
	3
<u>Miscellaneous</u>	
Assistant to the President	1
	1

F. *Does any such committee or individual have special responsibility for:*

	Yes	*No*
approval of product design (127)	73	54
approval of a product for manufacture (127)	66	61
approval of advertising (128)	74	54
recall of a product (125)	69	56
settlement of product claims (130)	85	45
control of product liability litigation (130)	93	37
insurance coverage (131)	87	44
approval of instruction manuals (126)	83	43
other:		

(1) special responsibility for regulations and codes

(2) approval of warning signs and labels

(3) tracking claims; investigating claims

(4) accident investigation; selection of defense counsel; authority to try or settle; selection of expert witnesses; determination of whether to cross-file against suppliers or dealers

In pursuing the general question of how a company may be organized to anticipate and deal with products liability questions, we asked whether or not any committee or individual assigned to this area had special responsibility for a variety of pertinent management decisions. Beyond these decisions, which are covered in the summary of responses appearing above, respondents were asked to indicate additional areas of decision or action for which any such committee or individual might have responsibility. (Slightly differing numbers of companies answered the individual questions; the number of respondents to each is shown in parentheses.)

	Yes	No
G. *Have you a written corporate policy on the retention of records (e.g., design, manufacturing, purchasing, testing, inspection, pertinent standard operating procedures, etc.) which may affect potential products liability claims?* (181)	106	75

Any manufacturer may one day face the necessity of proving in court the care with which his product was designed, manufactured, tested, etc. On such an occasion corporate records are an indispensable element of the necessary proof--hence this question. There were 181 responses including 106 companies who said "Yes" and 75 companies who said "No."

	Yes	No
H. *If the answer to "G" is "Yes," is such policy strictly enforced?* (101)	77	24

Accompanying comments provide at least some suggestion that companies which have no such policy or, if they do, do not enforce it, are reexamining the question. And one says "Enforcement is a never ending battle."

IV PRODUCTS LIABILITY INSURANCE COVERAGE

	Yes	No
A. *Does your company have primary products liability insurance coverage?* (188)	180	8

If answer is "No," please comment

From those who said "No," we received such comments as these:

> . . . service policy with excess coverage above a sizeable deductible.

> Retro-rated policy with $25,000 retention [illegible]

> [illegible] self-insurance, $[illegible] per occurrence.

> After February 197[illegible] the company will self-[illegible] primary coverage.

> [illegible]

> [illegible]

> [illegible]

[illegible] coverage [illegible] coverage."

* * *

[illegible] primary coverage [illegible] below.

	Yes	No
Does your company have excess products liability insurance? ([illegible])	17[illegible]	9
Does your company have [illegible] liability insurance? ([illegible]6)	7[illegible]	[illegible]
Does your company have nuclear liability insurance? (1[illegible]7)	2[illegible]	1[illegible]3
Does your company have other specialized forms of insurance coverage involving the products hazard? (1[illegible]7)	27	160

	Yes	No
B. *If you have such insurance, do you consider it to provide adequate coverage?* (173)	159	14

(1) · if answer is "No," in what respect is it inadequate?

Negative comments were accompanied by such comments as the following:

Inadequate because of restrictive language.

Limits now available in the market may be inadequate.

Loss or damage to company's products not covered.

Does not cover design error.

Based on recent trends we have no idea what is adequate.

		Yes	No
(2)	*do you consider the cost reasonable?* (173)	93	80
(3)	*are you satisfied with the performance of your insurance company as to*		
	-- *preventing accidents* (150)	102	48
	-- *defense of actions* (165)	135	30
C.	*Have your products liability premium rates increased over the past five years?* (205)	194	11

If so, for what reasons?

As might be expected, not all those companies which said "Yes" commented on the reasons. However, 167 did comment--with each company usually suggesting several reasons--and their comments conform to a pattern with the same reasons being assigned repeatedly. An array of those reasons appears below with an indication of how many companies felt each such reason applied to them.

	Number of Respondents
Increased claims against, and losses by, respondent	51
General insurance market conditions	37
General rate increase	29
General experience in respondent's industry	20
Inflation	18
Generous jury awards	15
Increasing volume of litigation	11
"Consumerism" (including social and legal attitudes)	8
Increased sales volume	6
Increased severity of claims	5

[illegible]	
0 through $4,999	6
$5,000 through $24,999	[illegible]
$25,000 through $49,999	9
$50,000 through $99,999	15
$100,000 through $249,999	21
$250,000 through $499,999	6
$500,000 through $999,999	6
$1,000,000 and above	4
	77

[illegible]	
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
$1,000,000	[illegible]
$1,200,000	[illegible]
$2,000,000	[illegible]

In addition to those responses summarized above, one respondent, whose answer is not included, indicates a "corridor deductible" from $25,000 to $100,000. Still other respondents, having answered "No" to the basic question, indicate that they have deductibles on their products coverage by choice. No doubt this is literally true, but one cannot fail to ask if the choice may not have been influenced by the premium that would have been required without the deductible.

	Yes	*No*
E. *Have you had products liability insurance coverage cancelled?* (194)	30	164

If so, why? (Please comment)

An analysis of the reasons assigned for cancellation--and some companies assigned more than one reason--reveals a recurrent pattern. Of the 30 companies responding in the affirmative, 9 indicated cancellation was the result of the carrier withdrawing from insurance of the products liability risk. "Poor claims experience" was reported by 7 companies whose products coverage was cancelled. An additional 7 companies, indicating generally that no reason for cancellation by their carriers was cited, have suggested that it resulted from an obvious reluctance on the part of carriers to insure the products risk. Three other respondents reported cancellation by the excess or umbrella carrier. Other reasons, which are in part variants on the themes already noted, appear in respondents' remarks quoted below.

> Insurance company did not want to continue on risk even though there were no reported losses at time of cancellation.
>
> Reinsurer cancelled on basis carrier.
>
> Insurance cancelled even though company had no claims.
>
> Carrier got out of business in our State.
>
> Several refusals to renew despite accident-free record for 14 years.
>
> Insurance carrier moving away from unprofitable lines.

V THE COST OF PRODUCTS LIABILITY

A. *Some jurisdictions appear to have adopted the theory of "enterprise liability" on the assumption that the product manufacturer is the one best situated to distribute costs associated with injuries resulting from use or consumption of a product. It seems probable that little has been done in the direction of identifying and*

segregating the totality of costs thus to be "distributed." [illegible] *a step in that direction, would you please give us your best estimates, expressed as percentages, of the* [illegible] [illegible] *product* [illegible]

[illegible] *insurance premiums* [illegible] *sales* ______ [illegible]

[illegible] [illegible] [illegible]

Range	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
	[illegible]

[illegible] ______ [illegible]

[illegible] [illegible] [illegible]

Range	Number of Respondents
- 0 -	[illegible]
Less than 1%	[illegible]
1.0% through 4.9%	[illegible]
5.0% through 9.9%	[illegible]
10.0% through 24.9%	[illegible]
25.0% through 49.9%	[illegible]
50.0% through 99.9%	[illegible]
100.0% through 199.9%	2
200.0% through 499.9%	3
500.0% and above	3
	108

(3) *internal costs not covered by insurance? (As a percentage of the insurance premium)* ___% (126)

NOTE: "Costs not covered by insurance" might include the amount of any insurance deductible, staff salaries and overhead, costs of investigation and claim settlement, costs of litigation, etc.

Of the 126 responses, 23, or nearly a fifth, indicate zero internal costs covered by insurance. The full summary appears below.

Range	Number of Respondents
- 0 -	23
less than 1%	27
1.0% through 4.9%	16
5.0% through 9.9%	8
10.0% through 24.9%	24
25.0% through 49.9%	13
50.0% through 99.9%	6
100.0% through 199.9%	5
200.0% and above	4
	126

B. *By what percentage, if any, has the* total *of such costs increased over the past five years?* _______% (159)

There were 159 responses to this question with 93, or 58 percent of the total, distributed between the 100% and 1,000% marks. The full summary of responses follows:

Range	Number of Respondents
- 0 -	10
less than 10%	1
10.0% through 24.9%	7
25.0% through 49.9%	13
50.0% through 99.9%	16
100.0% through 199.9%	34
200.0% through 499.9%	27
500.0% through 999.9%	32
1,000% through 1,999%	13
2,000% through 3,999%	3
4,000% and above	3
	159

VI NEW PRODUCT DEVELOPMENT

[illegible] evidence that the upsurge in products [illegible] has [illegible] the development of [illegible]

[illegible]

[illegible] created by [illegible] respondents offered [illegible]

[illegible] of aircraft.

[illegible] several [illegible]

[illegible]

[illegible] greater [illegible]

[illegible]

[illegible] have been [illegible]

[illegible] engineering personnel [illegible] restricting and stagnating [illegible]

[illegible] risk is a consideration in [illegible] and introduction of [illegible]

Engineering effort was diverted from product improvement to retrofit 25 to 50 year old machines.

Certain tools are being phased out of the market.

We have discontinued a line of controls . . . because of the products liability claims generated.

We have discontinued selling (and joint development of) products which operate in line with ours. We also will not import products developed and made by our licensee.

We considered products liability insurance costs and potential claim costs in the development of advanced medical ____ to be such that we redirected product development into other fields.

[No] . . . however, serious consideration has been given to eliminating some products and accessories to products.

Products liability experience with a ____ line was the impetus for disposing of the product line. In future, other product lines may be affected.

Have reviewed products in group and discontinued ____ products.

Some old products are being redesigned. While this is a discontinuance it has placed emphasis on new product development.

Several examples wherein customers have shown need for new products . . . and which we could have developed . . . but which were delayed or abandoned because of products liability.

Present research expenditures are being allocated towards areas of less exposure to consumer and liability problems.

VII POSSIBLE APPROACHES TO A SOLUTION

We are aware that many member companies have already considered possible legislation or other solutions to the products liability problem. MAPI is not committed to a particular solution at this time. A variety of proposals which have been advanced are listed below following two general questions. We would appreciate your reaction to them, but we are particularly interested in your suggestions as to how this continually enlarging problem may be solved, or at least made manageable.

	Yes	No
A. *If products liability is a problem for your company, do you believe it can be solved without legislation (e.g., through contractual indemnification, court-made law, etc.)?* (187)	18	169

If so, how?

Although comments were specifically requested only in the case of an affirmative response, those who believe no solution is possible without legislation also had their say. Representative comments, both pro and con, appear below.

Legislation Not Required

Attorneys through Defense Counsels' Association should try to change rules of procedure to require acceptance of presumptions in favor of manufacture in event product has long since left its control or that product has been significantly modified by employer. Provision for these presumptions provided for in Restatement [of Torts] 2nd, Section 402 A [illegible] disregarded or ignored by courts.

Existing insurance mechanism will adjust to distribute costs. Total costs will be passed along as part of product cost.

Contract indemnification better than legislation.

Any legislation would involve social consequences as a result of consumerism. Rather than look to that to minimize the problem, companies should improve quality control, install design review, maintain in-line inspections, maintain adequate records, review advertising methods, etc., to be in a position to know the products and be able to defend.

Legislation Required

Largely a third party problem. Therefore, solvable by contract indemnification only in a limited way.

As a supplier of OEMs we cannot require indemnification successfully.

Contractual indemnification ineffective.

Federal legislation is the only way out.

B. *If you think legislation is necessary, should it be*
/__/ *Federal or* /__/ *State?* /__/ *Both Federal and State?*
(175)

Federal	81
State	17
Both	77

Comments:

An analysis of accompanying comments reveals that 31 respondents favoring federal legislation stress the need for uniformity in the law as it affects products liability. A representative collection of comments appears below. Specific suggestions for legislative action appearing at this point in many responses are not quoted here, but rather are reserved for inclusion in the compilation of suggestions appearing at the end of this report.

Favoring Federal Legislation or Federal/State

It would be difficult and expensive to operate under 50 state laws.

State legislation would be non-uniform and result in "forum-shopping."

Federal Products Liability Act administered by State and Federal Courts.

[Favor federal legislation] . . . providing federal statutes could override state laws.

Federal legislation for uniformity but State legislation is required for limitation of actions.

Favoring State Legislation

Preferably State, but State and Federal if necessary.

No additional legislation. Government regulations are a Pandora's box.

Most applicable statutes (statutes of limitation and workmen's compensation) are state matters. May require federal legislation for uniformity.

Local problems should be resolved at local level.

"Consumerism" too deeply embedded in anticipations for federal legislation to do whole job. [Editor's note: This is reminiscent of another comment on the locus of possible legislation which asserted that it is " . . . necessary to curb 'welfare-consumerism'do-gooder' philosophy which is poisoning the country."]

C. *Certain proposals for solution of the products liability problem are listed below. Would you please indicate your reaction by a "favorable" or "unfavorable" answer and any comments you may have on any or all such proposals.*

	Favorable	*Unfavorable*
-- *making "no-fault" legislation--either mandatory or elective--applicable to products liability* (195)	79	116

Comments:

Again, there were strongly held opinions both _pro_ and _con_, but mostly _con_, as reflected in the sample of accompanying comments which follows. To ensure that the respondent's sometimes cryptic observation is fully understood, we have indicated in each case whether the vote was "favorable" or "unfavorable."

> Cost benefits of "no-fault" are illusory. Will not solve problems fairly since it will not penalize the party at fault. (Unfavorable)
>
> Social implications would dominate and our costs would be loaded by underwriters to provide for claims which should be defensible. (Unfavorable)
>
> Massachusetts' "no-fault" auto experience too unfavorable to consider "no-fault" here. (Unfavorable)
>
> ["No-fault"] . . . tends to reward people who disregard safe practices. Duplicates workmen's compensation and unemployment compensation and would permit double recoveries. Would also increase insurance premiums. (Unfavorable)
>
> "No-fault," with addition that workmen's compensation and all collateral sources be treated as an offset. (Favorable)
>
> Cost of defense of products liability actions is usually far greater than court awards. This has contributed to insurance cost. "No-fault" will eliminate much costly litigation. (Favorable)
>
> "No-fault" should have a trial period of evaluation. (Favorable).
>
> Desirable to continue to adjudicate fault. (Unfavorable)
>
> . . . If basis of payments is clearly defined and amounts are reasonable. (Favorable)
>
> While this would reduce cost of defense, it would increase number of claims. (Unfavorable)
>
> No solution if it works as poorly as no-fault auto insurance has worked in Massachusetts. (Unfavorable)

In the history of the world, removal of responsibility from a person for his acts has never solved a problem. (Unfavorable)

If limits can be set, it would be very helpful. (Favorable)

Recommend "no-fault" products liability legislation to cover where the product is certified as having met acceptable standards; otherwise common law to prevail. (Favorable).

Do not favor low-risk companies subsidizing others. (Unfavorable)

Preferably mandatory. (Favorable)

-- *changes in workmen's compensation legislation to:*	*Favorable*	*Unfavorable*
(1) limit products liability exposure (187);	161	26
(2) make possible a contribution from a negligent employer (191); *or*	153	38
(3) provide that recoveries under workmen's compensation or hospital/medical insurance by injured workmen should be permitted as an offset against recovery (187)	164	23

Please describe changes you would recommend:

Changes recommended were numerous and wide-ranging and, to some degree, contradictory. For the most part, certain suggestions recur. Each such general recommendation is stated below indicating the number of respondents who support it.

Recommendations	Number of Respondents
The employer should be made responsible where a work-related injury is caused by his negligence.	33
Workmen's compensation should be made the sole remedy for a work-related injury.	21
Subrogation to an injured workman's rights by a workmen's compensation insurance carrier should be prohibited.	15
Workmen's compensation benefits should be raised to realistic levels.	11
Manufacturers should not be permitted to sue employers.	6

Recommendations	Number of Respondents
Workmen's compensation benefits should be offset against products liability recoveries.	[illegible]
If an employer violates state or national safety requirements, joining him as a defendant in a products liability case should be permitted.	[illegible]

Beyond this summation of general comments, a number of individual comments are of interest.

Contributory negligence should be available as a defense against both employee and employer.

Workmen's compensation is the original "no-fault" concept. Ergo, it should be the sole remedy and the subrogation of rights to insurance carrier should be prohibited.

All parties potentially responsible--employer, employee and manufacturer--should be given a single hearing to determine relative responsibility and liability.

	Favorable	Unfavorable
-- [illegible] products liability suits [illegible] a quasi-public agency [illegible]	91	9[illegible]

[illegible]

A sampling of comments with "favorable" and "unfavorable" grouped separately appears below.

Favorable

Fine for those [products] which can be certified if at reasonable cost.

Immunity may be too strong but certificates should be recognized and given strong weight.

Composition of quasi-public agency is critical.

[Favorable] provided realistic standards are drawn.

Legislation would be helpful. Even though ___ meets Federal safety standards, there is no immunity from suit, since these are considered minimum standards. Evidence that standards are met should be conclusive.

Unfavorable

Do not believe approach is feasible.

Such agencies have rarely accomplished their objectives. Manufacturers do not need additional agencies regulating them.

A setup for bribery. Also impossibly bureaucratic.

Of doubtful practical value and probably not legally permissible.

No agency could possibly possess required expertise in all areas.

	Favorable	Unfavorable
-- *proof of compliance with applicable safety and health legislation regulations to serve as a defense in a products liability suit* (197)	166	31

Comments:

In this case there was a clear, indeed overwhelming, majority in favor of the proposal as stated. A representative selection of respondents' comments on this suggestion--classified according to the view expressed by the commentator--follows. The comments chosen reveal not only solid conviction but dubiety and a considerable element of hope.

Favorable

Federal standards would be preferable to state standards.

Should be accepted as a defense to design defect allegations--not to defective workmanship or materials. Leave as a jury question whether or not safety and health regulations are in keeping with the state of the art.

Certification by recognized testing laboratories (e.g., Underwriters' Laboratories) should be admissible.

Should be more than a defense. It should create a conclusive presumption.

An affirmative defense but not an absolute defense.

. . . getting jural recognition of state-of-the-art is extremely difficult. If it can be accomplished legislatively, good!

Excellent in concept, but who approves? Do we want such approval?

Unfavorable

Even with full compliance all possibilities would not be covered and thus compliance would be an inadequate defense.

Such certification might be [illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	39
[illegible]	[illegible]	[illegible]
[illegible] ... of the product by a third party (201)	[illegible]	6

Comments:

The consideration of these proposals evoked a considerable number of comments by respondents. Inasmuch as the vote is overwhelmingly "favorable," those comments reproduced below have not been segregated according to the individual view of the respondent-commentator.

(a) Such legislation might be declared unconstitutional; (b) A statute of limitations is a must. No product will remain safe forever.

Prime manufacturers should assume liability for entire product, including components, to eliminate duplicate insurance and expense.

Recovery should be sufficient to make the injured party whole. [However, there should be] . . . limitations on pain and suffering, loss of consortium, etc.

(a) Where a maximum recoverable amount is set, the maximum is generally sued for regardless of injury; (b) and (c) are already provided for in Restatement of Torts (2).

It is unreasonable and ridiculous that we had to defend ourselves in 1971 on a machine our predecessor shipped in 1929 which had changed hands several times. The user must be made responsible for safe operation whether he modifies machine or not.

(a) Amounts of recovery should be set by appointed fact-finding panel based on the injured person's current earnings and future earning capacity--not by a court; (b) a reasonable period from first use; and (c) comparative negligence principle should apply.

A ceiling is undesirable under (a). The jury would always give the maximum.

(a) Limit to amount obtainable under workmen's compensation; (b) liability should be limited to some percentage of estimated or actual life cycle; (c) only if causal connection can be shown between alleged defect and modification or alteration.

This is a very difficult area involving many issues of public policy and cannot be dealt with in summary fashion.

(a) Specific limitations by law on amounts recoverable for pain and suffering is needed to prevent run-away verdicts based on sympathy; (b) This type of legislation is definitely needed to permit insurers to foresee the risk and set rates accordingly and to eliminate unforeseen liabilities when transferring ownership of companies; (c) Needed is legislation limiting the judicially imposed rule of "foreseeable misuse."

	Favorable	Unfavorable
-- *the imposition of defensc costs on the plaintiff if he is unsuccessful in his suit* (196)	156	40

This is a very popular suggestion. Despite the proposal's popularity, there are a number of thoughtful dissents among the selection of respondents' comments appearing below.

> Definite deterrent to "shotgun" attorneys working on a percentage.
>
> Highly recommended to reduce number of spurious claims.
>
> Would be unfair to many individuals who have no other way to seek a remedy.
>
> Injured employee should not be responsible but attorney who took his case should be.
>
> This would eliminate about 75 percent of claims filed.
>
> Such action would be unduly restrictive and would prevent plaintiffs with legitimate complaints from seeking legal redress.
>
> Would eliminate nuisance suits.
>
> Conversely, plaintiff ought to recover costs if he is successful. This would encourage more settlements and less trials.
>
> Charge defense costs to unsuccessful plaintiffs. Have plaintiffs' attorney's fees determined by court in accordance with quality and quantity of legal work done--not a flat percentage.
>
> So long as contingent fee system exists frivolous suits will continue.

D. *What is your suggestion for solution of the products liability problem? Please discuss*

There were 130 respondents who made specific suggestions for solution of the products liability problem. As in the case of proposals for change in workmen's compensation legislation, a majority of responses voiceo recurrent themes. In attempting fairly to summarize this outpouring of suggestions, we have, first, summarized below in our own language common recommendations together with the number of responses which agreed to each, and, second, we have quoted a number of other suggestions which follow no pattern but nevertheless deserve to be noted.

General Recommendations

	Number of Respondents
Eliminate contingent lawyers' fee.	38
Make employer responsible where a work-related injury is caused by his negligence.	33
Enact a statute of limitation governing manufacturer's liability. (Included suggestions: (1) 10 years from date of first sale to first user; (2) make time coincide with depreciation schedule for particular machine; (3) alteration or misuse of machine should free manufacturer of liability; (4) limit liability to ownership by original purchaser; (5) apply higher standard of proof if product has performed satisfactorily for a specified number of years.)	26
Limit the amount of awards. (Including three who specifically noted limiting awards for pain and suffering. It seems likely that others intended this in calling for a limitation on "awards.")	24
Make workmen's compensation the <u>sole</u> remedy for a work-related injury.	21
Improve product quality.	20
Apportion fault between manufacturer and employer and other defendants in a work-related injury.	11
Limit or eliminate altogether the doctrine of strict liability.	10
Negligence should be punished.	5
Educate public to seriousness of products liability problem.	5
Defend all products liability claims vigorously.	5
Abolish punitive damages (including suggestions that any punitive damages awarded should be to State and not the Plaintiff and no contingent legal fees should be allowed thereon).	4
There is no one solution.	4

	Number of Respondents
Settle product liability cases by administrative rather than judicial action (including related suggestion to eliminate jury trials for product liability cases).	
[illegible] product liability [illegible] "[illegible]."	
Authorize judgments for continuing support rather than present value of future support.	-
[illegible] at least half the [illegible] in the [illegible].	-

Individual Suggestions

The solution lies in prevention of [illegible] design, development and pre-production evaluation [illegible] as well as traditional quality control activities with manufacture.

* * *

Since the problem is really a result of legal attitude which is becoming increasingly [illegible] and will probably not reverse, we recommend a "no-fault" approach.

* * *

Should differentiate between personal injury and property damage claims/lawsuits.

1. Personal injury claims/lawsuits

    a. Eliminate the collateral source rule except for individually purchased insurance coverages.

    b. Eliminate workmen's compensation subrogation and/or recovery.

    c. Allow a manufacturer a right of action against employer for its negligence without defense of workmen's compensation being an exclusive remedy.

d. Modify strict liability (Restatement 402a) to allow comparative negligence to reduce damages in accordance with plaintiff's failure to act prudently.

e. Statute of Limitations to run from date of first sale to first user.

2. <u>Business or corporate property damage</u>

a. Eliminate all causes of action except those under the UCC or negligence actions.

b. Statute of Limitations to run from date of sale in negligence cases.

(UCC Statute is now from date of sale.)

* * *

Consider a simple piece of equipment--a knife. Who cuts fingers with them? Obviously, the user. If knife manufacturer must be responsible for use he has two choices: One is to liquidate before going broke or going broke.

* * *

No class action suits without permission of claimants. Entire punitive damages award goes to state, no attorney's fees allowed. Reduce attorney's fees as claim increases. Strict liability rule only to first purchaser.

* * *

Legislation counteracting the strict liability theory as propounded in the Restatement of Torts [2] and case law would be desirable. If we move back toward a negligence-contributory negligence stance, . . . much of the product liability problem would be solved . . . . If a strict contributory negligence theory is considered too harsh, a comparative negligence theory can be considered.

Although Federal legislation appears to be needed to help correct a worsening product liability situation, I am disturbed by some of the suggested types of legislation heretofore mentioned. Striking out in a number of directions with immunity, no-fault, amending workmen's compensation legislation and setting up new

quasi-public bodies is not the answer. These suggestions are either impractical to implement through legislation or potentially undesirable if implemented.

Attempts at obtaining clearer standards for manufacturers to comply with and use of compliance as a defensive tool would go a long way toward correcting the present situation. If this were coupled with a legislatively endorsed return to the negligence-contributory negligence theories, the defensive posture of a manufacturer would be considerably improved.

This approach would not alleviate all product liability cases. No approach could, or should attempt such a sweeping change. If we face facts, we will have to admit that some product liability cases are justified. This approach does, however, have attributes to commend it. First, manufacturers would have clearer standards to comply with. Some such standards now exist thru OSHA, ANSI, and other bodies and others could be promulgated. Second, manufacturers would be more likely to comply with the standards if non-compliance could be used as evidence of negligence, but compliance could be used as evidence of non-negligence. Third, it would make the claimant responsible for his/her irresponsible acts that contributed to the injury. In other words, it keeps "fault" in the system. Fourth, it is clearly workable within our present judicial set-up and has, in effect, worked in the past.

* * *

The Federal government and states set limits on awards for damages other than property and medical. States [should] have a body which consists of five regular members and four outside "experts" in a particular case to act as judge and jury. Remove emotional decisions and awards. Appeals may be made through the state or federal court system at the appellate level. Loser pays all costs.

* * *

Place heavy evidentiary burden on plaintiff alleging a product defect if product has been in use ten years or more without prior sign of defect.

* * *

General insurance like automobile "no-fault" plus workmen's compensation tied to cost of living

index and adjusted to provide reasonable compensation. Go back to doctrine of privity and proved negligence rather than strict liability.

* * *

If management has the resources to design, produce and market its products, then it can also manage its liability exposure. If public demands quality and safe products, manufacturer should price accordingly.

Mr. STEWART. I call the committee's attention to the fact that a most recent questionnaire which we took by Telex is briefed on page 2 of our statement, and would be a part of our complete statement.

I think there are some things of a general nature that should be said. First of all, this is not exclusively or primarily a small business problem. It is a problem which cuts across all industry, all sizes of companies, and therefore I welcome and the institute which I represent welcomes an opportunity to address the subject in the context of a committee with a much broader jurisdiction than small business.

There are two points that should be mentioned of a technical nature. We would assume that if legislation along the lines, excluding the Treasury proposal, which is before you were enacted it would preempt a ruling of the Financial Accounting Standards Board which restricts the use of the type of reserve that is contemplated by our statement and by the bills that are before you.

If that would not be automatically the case, then if this subcommittee were to adopt any such proposal, its legislative history should preempt FASB 5, which is the standard to which I refer. Also, in the event there is any conflict in the law, assuming a bill along these lines were passed, we would feel that the legislative history should deal with the question of the tax penalty for unreasonable accumulated earnings.

Another general statement. You will hear, perhaps today you will hear allegations that any such legislation of a supportive nature for a manufacturing business confronting this problem would reduce the incentive to have a safe workplace. This is a specious argument. I do not know of a single company in MAPI, regardless of size, which does not place a very high priority on the matter of workplace safety. It is good business as well as being appropriate social consciousness.

We have take exception to the complicated approach of the bills before this committee with respect to placing a limit on the availability of a deduction. We propose a much simplier cap, so to speak, in the form of a specific amount. We believe that we have to be responsible about this aspect of the situation, but the language of the two bills is unnecessarily complicated, and at the same time results, in effect, in a ceiling which is much too low.

Generally speaking, the Treasury proposal is a no-solution proposal. In the name of simplicity, too much is coming before the committees concerned with taxation in the Congress, and when the Treasury runs out of rationalizations other than simplification, it uses simplification, whatever the issue may be.

I will be pleased to answer any questions. We certainly do not want to intrude on the committee's time. Thank you, sir.

Senator BYRD. Thank you, Mr. Stewart.

The next witness is Mr. Walter D. Vinyard, Jr., on behalf of the American Insurance Association. Excuse me. Senator Packwood, did you have a question of Mr. Stewart?

Mr. PACKWOOD. I did not get to read your whole statement, but on page 2 of your summary, "As for the measure of tax deductibility in any year, we tend to favor the estimated cost of products liability insurance," I guess what you are saying, if I read it right, is that what you want to be able to set aside is roughly the amount you now pay in premiums for the product liability insurance. Is that right?

Mr. STEWART. We say that is one approach. As a matter of fact, an absolute dollar ceiling we refer to in our statement is one part of that approach. Obviously, some sort of ceiling is necessary. We are not inflexible about what that ceiling should be, except that the proposals before the committee include ceilings which really exclude applicability for most companies.

Senator BYRD. Thank you. Mr. Vinyard?

STATEMENT OF WALTER D. VINYARD, JR., ON BEHALF OF THE AMERICAN INSURANCE ASSOCIATION

Mr. VINYARD. Thank you, Senator Byrd, Senator Packwood.

I realize there are time constraints this morning. I have a number of studies and reports on this problem that I would like to introduce in the record. I would be happy to answer any questions.

The American Insurance Association, whose members underwrite 85 percent of product liability insurance sold in the United States, is strongly opposed to amending the Internal Revenue Code in order to provide tax deductions and tax exempt trust funds for self-insurance against product liability or other casualty liability risks. The current tax treatment of self-insurance and commercial insurance under the code is balanced. Insurance premiums are deductible when paid. Losses paid by an insurance company are not deductible. Property casualty insurers are taxed currently on income. No structural changes are needed in the code. The deficiencies of self-insurance have nothing to do with taxation.

Self-insurance for most manufacturers is nothing more than a voluntary bookkeeping segregation of assets. The self-insurer continues to control its funds and may liquidate them at will. When a manufacturer purchases insurance from a company fully regulated by a State insurance department, the manufacturer transfers risk of loss to an independent concern regulated for solvency. Even if the regulation fails, the State commissioner and other companies doing business in that jurisdiction guarantee payment of claims by injured consumers.

Our members question whether a serious product liability insurance problem exists today. Significant changes in the law of strict liability by State courts did result in dramatic increases in insurance claim costs. Hazardous industries found insurance premiums increased from 100 to 500 percent, as a result of the way State courts applied tort law. There was no single event to which anyone could point as causing cost increases. Unexpected cost increases produced temporary dislocations in the insurance market. Those dislocations are behind us. Twenty-six States have created market assistance programs to help impacted industries locate insurance coverage.

Approximately 800 companies have submitted MAP applications nationwide. In many cases, MAP finds an underwriter by exploring every available market. Often brokers or agents cannot do this alone. Several State MAP's are experiencing lower activity in recent months. A number of other State MAP's have never received more than a few applications. I have a report on the current situation in the various States for the record.

Product liability insurance costs are estimated to be less than one-half of 1 percent to 1 correct percent of sales. Generally, it is the small manufacturer of a single product which is forced to pay more than 2 percent of sales.

Advocates of tax incentives for self-insurance explain they want to help large small businesses. Encouraging small businesses to self-insure through tax incentives is an unworkable concept. It will not reduce the aggregate demand for insurance coverage by small business. It will not produce lower prices for insurance purchased by small business. It could mislead and fail to compensate injured consumers.

Product liability self-insurance must have two objectives. The self-insuring business must be able to spread its exposure to losses evenly over a period of years. It must also be able to compensate injured persons quickly. To do this, a self-insurer must accumulate and maintain a substantial pool of assets. Large corporations with product diversity, and sizable cash flow are doing this without tax incentives. Small businesses cannot.

A report by the National Federation of Independent Business discovered that 42.8 percent of small businesses responding could not establish a trust fund.

Senator BYRD. Thank you, Mr. Vinyard. Senator Packwood?

Senator PACKWOOD. Mr. Vinyard, I assume that if the insurance companies are playing fair with the industry and the industry wants to genuinely self-insure, the amount that they will set aside in reserves will be somewhat equivalent to the amount they now pay in premiums. Is that correct?

Mr. VINYARD. I would hope so. I would hope they would set at least that amount aside.

Senator PACKWOOD. I would, also, assuming that indeed the insurance industry is dealing fairly with them. Otherwise, they will be dramatically underinsured for many of their losses.

Mr. VINYARD. Right.

Senator PACKWOOD. But if it is roughly the same amount, why is there a tremendous loss to the Treasury? If they can now take the deduction as a business deduction for premiums, why will there be a tremendous loss if they take the same deduction for insurance reserves?

Mr. VINYARD. The tax loss to the Treasury is substantially larger for one particular reason. Once you set up a tax incentive in the Internal Revenue Code, there are many people who will set up trust funds just to take advantage of the favorable treatment under the code.

Senator PACKWOOD. But if there is no more favorable treatment, they could take a business deduction now for their insurance premium.

Mr. VINYARD. Yes, but to put it on tax-exempt basis is a much more favorable treatment than now exists under the code.

Senator PACKWOOD. Why?

Mr. VINYARD. Insurance companies are taxed currently on income. Self-insurers under the proposal before you would not be. They would be tax-exempt.

Senator PACKWOOD. They would have the same deduction for their premiums. Whatever income they earn on their assets under the bill would be exempt, but I find it hard to believe you would have a loss ranging from $12 billion to $23 billion from the Treasury based solely upon that tax-exempt status.

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Mr. VINYARD. The report prepared for us by Andrew Brimmer estimates that the loss to the Treasury which would result from enactment of product liability self-insurance legislation could range from $36 million to $12 billion depending upon the specific alternative. S. 3049 would increase the revenue lost to the Treasury from $106 million to $296 million.

These figures are from an August 15 report to us by Brimmer and Co., and I regret, Senator Packwood, that the preliminary copies of my statement that were filed with the Finance Committee office on Saturday morning contained an error in the paragraph that you quoted. I regret that very much.

Senator PACKWOOD. Excuse me. Say that again.

Mr. VINYARD. The preliminary copies of the statement that were filed with the Finance Committee on Saturday morning contained a clerical error on the revenue loss.

Senator PACKWOOD. From $12.3 billion to $23.2 billion is a clerical error?

Mr. VINYARD. Yes, the range is from $36 million to $12 billion, depending upon—[General laughter.]

Senator PACKWOOD. You know, now I do not know which is worse now. [General laughter.]

Senator PACKWOOD. A range from $12.3 billion to $23 billion or a range from $36 million to $12.3 billion. At least I like the latter better. It is only $12 billion.

Mr. STEWART. Senator, may I intervene at this point?

Senator PACKWOOD. Yes.

Mr. STEWART. First of all, I am in complete disagreement with what has just been said. I have talked to Treasury people, by the way, for 20 some years about revenue estimates, and they are never right. [General laughter.]

Mr. STEWART. What you deal with before a committee of this sort is always a model or something based upon wrong assumptions.

Senator PACKWOOD. You do not have to assure this committee about Treasury's wrong assumptions. [General laughter.]

Senator PACKWOOD. I am just curious where the figures in paragraph 8 on page 3 came from, because I cannot imagine that the total insurance premiums paid for products liability insurance come any place close to $23 billion a year. Maybe they do.

Mr. VINYARD. No, you are correct. They do not, but the revenue estimates are based on the fact that many other corporations who are now not paying insurance premiums for product liability would have an incentive under the Internal Revenue Code to set up a tax-exempt trust fund.

Senator BYRD. If the Senator would yield at that point——

Senator PACKWOOD. Yes.

Senator BYRD. Why is there a greater incentive under the proposal than under the current situation? The premium is completely tax deductible as a business expense, is it not, under the present code?

Mr. VINYARD. Yes, sir, but the reserves are not tax-exempt.

Senator PACKWOOD. I understand the reserves are not tax-exempt, and assuming the reserves are invested cautiously, and return 6, 7, or 8 percent, surely that cannot be the difference of this revenue loss.

What you are saying is that maybe they could reduce the costs that they put into their trust fund over what they now pay for the premiums by the amount of income that will be generated by the tax-free assets of the trust. How much is involved in premiums in product liability now? It just cannot be close to that figure.

Mr. VINYARD. You are correct. I would not want to make passage or failure of passage of any legislation, depend upon the revenue loss figures. Our primary objection is based upon the studies which we have done of small businesses which insure today. It is simply not a feasible concept for small businesses.

Under the code, other industries such as commercial banks or insurance companies which are given treatment for reserves have it conditioned upon their actual experience. When they run into an unusually large loss a carryback is allowed. This is always the case in product liability. These claims come in perhaps once in a decade, and when they come in they are astronomical. In that case, the Internal Revenue Code should give other businesses an extended net operating loss carryback.

Senator PACKWOOD. I can see what is going to happen, and I think I agree with you on the small company set-asides. For example, there is a school bus full of children riding on tires that have been retreaded by a company, and there is an accident with 10 or 15 children killed, and the company held responsible in the product liability case does not have the money. They have not set it aside. There is a national scandal, and we have set up a Federal bureau of product liability reinsurance vesting, or something like that, and begin to supervise all businesses in this country based upon the example of one or two gross failures.

I have seen this happen over and over, and it will happen again. I am not sure that this is the road we want to start down.

Mr. MACK. Senator, may I respond to that? That is true under current law. If Mr. Secrest's company or some other smaller member of ours cannot afford insurance and self-insures—not because it has a tax incentive but because it has to—and cannot satisfy a claim, the danger of unsatisfied judgments exists under the law today. The carryback proposal that the Treasury has suggested will alleviate that problem to some degree, and that is why we think it ought to be adopted along with the reserve. But the reason that our people need the reserve is not because they want to be in the insurance business. However, they do want to prudently set aside funds against defense costs, and other smaller, sure to come, recurrent but irregularly timed losses that will occur over a period of time.

Senator PACKWOOD. Is there any reason why we should give you an advantage over insurance companies by making your reserves tax-free and theirs taxable for the same insurance?

Mr. MACK. It is my understanding, Senator, under one of the bills that the reserve fund may be tax-free. But that under the other bill, it is not.

Senator PACKWOOD. Thank you.

Mr. STEWART. The Senator should bear in mind also that not only are premiums going up but the deductibles are going up.

Senator BYRD. The next witness is Mr. Robert Clements, on behalf of the National Association of Insurance Brokers.

STATEMENT OF ROBERT CLEMENTS, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE BROKERS, INC.

Mr. CLEMENTS. Thank you, Mr. Chairman.

I am Robert Clements, executive vice president of Marsh and McLennan, Inc., today representing the National Association of Insurance Brokers. The NAIB members arranged the bulk of the property and casualty insurance purchased by business consumers. Our fundamental purpose is to consult with businesses of all sizes on the best and most economical means of protecting against the types of risk that arise from the conduct of a business enterprise.

While some continue to debate the question of whether or not there is a crisis in product liability insurance, that seems a bit academic. There is no doubt that there is a severe and continuing problem and no doubt that it is one aggravated by the fact of inadequate capacity in our domestic insurance industry. Total available insurance capacity falls short of delivering the limits of liability that are adequate for the needs of many businesses, especially smaller and high risk enterprises. These should have a viable option to self-insure against losses.

The pending legislative proposals are a response to the extreme difficulties encountered in the purchase of insurance in the area of product liability, but the primary objective of tax equity is not merely to provide tax relief. The ability to expense a reserve is no substitute for insurance. It is merely a device to recognize that where insurance is not available or not required because the amount to be self-insured is financially bearable, there ought to be some provision to deduct the amount set-aside to pay anticipated losses. That is a reasonable and justifiable premise in itself, especially since insurance companies enjoy that privilege now, but the real objective of the proposals is to make insurance available at reasonable cost.

The shortage of insurance is largely attributable to the lack of underwriting capacity.

Senator PACKWOOD. Excuse me. What did you just say?

Mr. CLEMENTS. I said the shortage of insurance is largely attributable to the lack of underwriting capacity. Tax equity is a device to restore the balance between supply and demand by reducing demand. The present tax law has worked to create an incentive to purchase more insurance than is actually needed for risk protection by favoring the purchase of insurance over other means of funding risk.

Many companies which have the capacity to take quite large deductibles are influenced by tax provisions to purchase full coverage when available as the only way to realize a tax deductible expense.

The two bills before the subcommittee attempt to achieve tax equity by permitting deductions for contributions to self-insurance reserves. NAIB strongly endorses this approach. We submit, furthermore, that tax deductions for self-insurance should be limited primarily by a standard of reasonableness, that is to say, to that which is actuarily sound, as opposed to the adoption of arbitrary limits as proposed in the bills before the Subcommittee.

We recognize that fixed dollars and percentage of sales limitations are introduced to limit abuse to the set-aside opportunity, but both approaches create problems as now designed. The dollar limitations are so confining as to render the proposals nearly useless as a means to in-

crease insurance availability. On the other hand, the percentage limitations are so liberal that it is hard to imagine they will have any practical effect. Better safeguards can be designed and simplicity of monitoring such funds would be better served if, for example, a lower sales percentage maximum were adopted and third party authentication were to be required.

NAIB also strongly supports equality of treatment for premiums charged by captive insurance companies. In this connection, we oppose as unnecessary and unrealistic the suggestion that deductions should be limited to premiums paid to domestic captives. Captives present certain advantages over self-insurance. By providing direct access to reinsurance markets, they create more efficient use of available insurance capacity, and they themselves represent additional capacity by their existence.

Favorable clarification of their status would foster their growth and greatly contribute to the goals of the bills under consideration. The concern that self-insurance and captives will reduce Federal tax revenue is unfounded. There is reason to believe that deductibility of payments for structured self-insurance programs can produce an increase in tax revenue. The amount contributed to self-insurance funds could consistently average in the area of 25 percent less than the amount necessary to secure conventional insurance for an equivalent risk. Since the deductibility of such contributions will lead to a significant increase in the practice of self-insurance and a corresponding decrease in the purchase of conventional insurance, the result to be expected is an increase in corporate profits with attendant benefit to both Federal and State revenues.

This would be offset only partially by a reduction in corporate tax revenue where a credit is given for risks already self-insured. The tax bill should be neutral and not make arbitrary distinctions between deductions. We urge most strongly your favorable consideration of legislation to produce that end. Thank you.

Senator BYRD. Senator Packwood?

Senator PACKWOOD. Mr. Clements, I understand your association represents, the principal commercial insurance sales companies. If General Motors wants to buy products liability insurance, you may place it with one of the insurance companies in the United States. Is that right?

Mr. CLEMENTS. Yes, sir.

Senator PACKWOOD. And if this bill passes, it would seem to me that there would be a natural decline in the amount of insurance your companies would place, assuming that a lot of people start to self-insure.

Mr. CLEMENTS. It is conceivable. We have for 75 years in the insurance brokerage business grown and prospered by recommending to our clients. We consider ourselves to represent the consumer of the policy rather than the insurer, and we have benefited by recommending to them what we felt was in their best interest.

Senator PACKWOOD. In your estimation, do you try to place insurance with a variety of different insurance companies in products liability?

Mr. CLEMENTS. Yes, sir.

Senator PACKWOOD. In your experience, do you find that the companies underwriting insurance, liability insurance, are unduly gouging the companies and making an exorbitant profit?

Mr. CLEMENTS. I would not put it that way. What I would say is that the ability to price product liability insurance is limited. It is perhaps the most complex underwriting problem that an underwriter faces, and our experience in buying insurance has convinced us of one thing. The more difficult it is to price a product of insurance, the more the cost of that coverage depends not on the actual assessment of the risk, which is virtually impossible to make, but on the relationship of supply and demand in the insurance industry.

Senator PACKWOOD. Is the reason that the risk is hard to assess because the losses are infrequent and big?

Mr. CLEMENTS. It is because the losses are infrequent and big and take a long, long time to settle. For example you questioned experience rating. Experience rating can be made to apply in product liability but the reaction time is kind of slow. You do not really know your experience for years after the issue of the policy.

Senator PACKWOOD. You would have to have 100 years of experience before you had a really valid track record.

Mr. CLEMENTS. Well, you would probably have to have 20 anyway.

Senator PACKWOOD. Thank you. Good testimony.

Senator BYRD. The next witness is Mr. Anthony Schopp, executive director, Machinery Dealers National Association, on behalf of the Small Business Legislative Council.

STATEMENT OF ANTHONY SCHOPP, EXECUTIVE VICE PRESIDENT, MACHINERY DEALERS NATIONAL ASSOCIATION, ON BEHALF OF THE SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. SCHOPP. Senator, the Small Business Legislative Council supports S. 3049 to provide American small business the chance to manage their enterprises in a logical, understandable manner during our country's economic morass resulting from the product liability crisis.

Our trade association is an international group including 400 U.S. members operating in the after-market of the machine tool industry, and supplying most of the industrial equipment used by small manufacturers. Our members are primarily small, family-owned companies with 5 to 50 employees. Annual industry sales are projected at just under $1 billion.

The Small Business Legislative Council is a federation of trade associations whose members are small businesses. SBLC focuses on issues of common concern in the small business community and represents approximately 4 million small companies. Forty-four national associations support the SBLC position that small business needs this opportunity if all are to survive the crisis that involves our Nation. This position is a reluctant, but very firm conclusion. The pride of American enterprise tends away from Government assistance, yet because they want to run their business independently and competitively, small businessmen must urge adoption of this legislation.

Current tax laws make it easier for large businesses to establish reserves with post-tax funds not being subject to accumulated profits taxation. The proposal to allow tax credit for product liability losses would help only a limited number of corporate taxpayers.

Adoption of S. 3049 would sufficiently address the bad position in which business is caught today. As you know, court interpretations encourage frivolous and expensive lawsuits and require defendants to prove innocence. An overreaction by the insurance industry has produced panic pricing with liability insurance premiums now costing more than many small businesses hope to earn annually.

The National Small Business Association, unfortunately, has an impressive collection of letters from firms throughout the country in all industries represented by the association supporting 3049, describing simply, accurately, and honestly the horror stories about the unavailability of insurance, and as mentioned earlier, unavailability and nonaffordability are synonymous.

Over half of our association [MDNA] members are forced to operate their businesses without liability coverage. This fact and others are found in the feasibility study for our consideration of setting up a captive insurance company in Bermuda. Should this occur, it will only occur because there are no other alternatives to obtaining insurance.

Two and three years ago, many of our members who had operated their businesses for 15, 25, and 30 years, without a claim paid about 50 cents per $1,000 of product liability insurance, with a small, if any, deductible. Today, these firms can purchase insurance for $20 to $24 per $1,000 with coverage limited to losses between $300,000 and $1 million. Some were told they could buy $100,000 of first dollar coverage insurance for $100,000. Some of these offers were proposals by insurers identified in the Marketing Assistance Programs.

Our members stopped trying to acquire coverage by the MAP's concluding it was a waste of time. For a small businessman, it is more logical and reassuring to set up a loss reserve, than to be told he can carry back losses 10 years rather than 3.

This committee realizes the income effect is superior to the tax effect when it enacted law permitting mining companies to establish reserve for black lung disease losses. We prefer the deductible reserve because it will encourage prevention techniques to avoid claims against one's own money. And frankly, small business feels the self-insurance concept is the best way to obtain fair coverage from an insurance industry which has been unreasonable in establishing premium rates.

Finally, our request is reasonable. The majority of all small businesses do not have product liability problems because of flawed products or services. Few actions go to court, and it is highly unusual for a judgment against, but the uncontrollable and untenable situation of our present tort system produces many suits and costly litigation.

For those few members who have a catastrophic loss, a carryback proposal will help and should be enacted. However, for the vast majority of businesses who are mostly small, a deductible reserve is the best way they can continue operating reasonably during the crisis.

Our goal is to remain, to paraphrase President Lyndon Johnson, to be taxpayers and not tax eaters, and I thank you.

Senator BYRD. Mr. Packwood?

Senator PACKWOOD. No questions.

Senator BYRD. Thank you, sir.

The last witness will be Mr. Robert Friedlund, on behalf of the Material Handling Institute. Mr. Friedlund?

STATEMENT OF ROBERT FRIEDLUND, ON BEHALF OF THE MATERIAL HANDLING INSTITUTE

Mr. FRIEDLUND. Thank you, Chairman Byrd and Senator Packwood.

My name is Bob Friedlund. I represent the Material Handling Institute, which is a trade association of 355 companies manufacturing about 85 percent of the material handling equipment made in this country. Our products include such equipment as lift trucks, hoists, automatic storage systems, conveyors, in summary, anything that moves equipment and material. Material Handling Institute has been vitally interested in product liability reform for quite some time, and our main effort has been concentrated in achieving product liability reform at the State level. For your information, 19 States have passed remedial legislation to return equity and balance to the tort system, which I think is very encouraging and demonstrates that there is general recognition that there is a problem, notwithstanding the insurance industry's recent statements to the contrary.

In Material Handling Institute's opinion, there are three pressing problems associate with product liability: One, the high cost and the unavailability of insurance. The tort laws need to be revised especially those laws dealing with strict liability. Third, and something we probably cannot do very much about, the psychology of entitlement prevalent in our country today.

Today, this committee is addressing, in Senate bill S. 3049, the Culver-Nelson bill, a part of one of these pressing problems. S. 3049 is an attempt to provide a fair and equitable way for manufacturers and sellers to obtain product liability coverage. The basic proposal is to provide tax relief to those who wish to or are forced to self-insure. The principle of a tax-free set-aside for product liability purposes has great merit, provided that the limits are large enough to be workable.

The building of such a fund provides several advantages. One, as the fund grows, higher deductibles can be purchased commercially from insurance companies, thus lowering premium cost. Two, a set-aside provides incentives for loss prevention by manufacturers and sellers. And three, it provides a competitive incentive for insurance companies to provide insurance at reasonable cost.

Material Handling Institute suggestions as to workable limits are as follows: We recommend $250,000 per year or the cost of obtaining needed coverage based upon market prices, whichever is larger. We would like the total fund to be at least $1,250,000. Dividends on investment of this tax-exempt fund should apply toward the limit of $1,250,000, and the fund should be used only to defray product liability cost. There should be strict rules to prevent the fund being used otherwise.

Recently the administration has suggested that the Internal Revenue Code be amended by extending the present carryback provision from 3 to 10 years. We think this approach has merit for a small number of businesses, so it should not be disregarded entirely. It is obvious, however, that no help will be forthcoming for companies whose profits are marginal or nonexistent, and for companies just starting in business. Also those who cannot presently obtain insurance

will not receive any help from this approach. However, it will help those who have been in business for some time, who have had large product liability costs and have had profits in the past.

If the carryback approach is used, Material Handling Institute recommends that a 3-year loss carry-forward be included whereby a tax credit is issued against future profits, and for those starting in the business or struggling to make profits, an additional 3-year carry-forward be allowed, resulting in a total of 6 years. Our concern is to try to help the new business, and the struggling business stay in business.

In order to incorporate these two basic approaches into law, to be fair to all concerned, Material Handling Institute recommends that the taxpayer be allowed a choice of which method would be best for him according to his circumstances. We think this is very important. We would like to try to help small business get started. Presently, people are staying out of business because they are afraid of the open-endedness of product liability. It would help, if the taxpayer had a choice as to which way to go.

The Material Handling Institute is extremely pleased to be able to testify, Senator Byrd, before this committee, because it is considering a much needed proposal which will reduce inflation in this country and help the businessman and the consumer live properly together.

If there are any questions, I will be glad to try to answer them.

Senator BYRD. Thank you, Mr. Friedlund.

[The prepared statements of the preceding panel follow:]

STATEMENT OF NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION

NMTBA is a national trade association comprised of about 400 members accounting for some 90% of the United States' machine tool production. Over 70% of these companies have less than 250 employees. The entire industry has approximately 92,000 employees.

We appear today in support of the integration of the concept embodied in S. 3049, introduced by Senators Nelson and Culver, with a 10-year product liability carryback provision endorsed by the Carter Administration. S. 3049 would permit a business tax deduction for self-insurance reserves set up to protect manufacturers against products liability claims, while the Administration proposal would extend the current three-year loss carryback provision to ten years for product liability losses. We support such legislation not by choice, but out of necessity.

A recent NMTBA survey revealed that seven-eighths of our members cite the actual or potential unavailability of adequate or affordable products liability insurance coverage as their Number One problem.

The results of this survey reveal the magnitude of the products liability crisis within the machine tool industry.

The average NMTBA member is paying $141,500 this year for primary products liability coverage. This figure represents a relatively modest 7% increase over 1977's average of $132,000. However, in 1976 the average products liability premium was only $71,000 which still seems large when compared to 1970's average of $10,000.

At present a shocking 20% of our members report no products liability coverage, and another 21% believe either their policies will be cancelled or that their premiums will be increased substantially within the next year. Moreover, of those members with products liability insurance, one-ninth seriously doubt the financial stability of their insurance carrier.

The percentage of members without products liability coverage is even higher among companies with gross sales of less than $5 million. Over one-fourth of these smaller companies cannot obtain or afford products liability insurance, even though most have had no claims experience whatsoever in 1977.

These statistics, as serious as they sound, become even more alarming when they are translated into percentage of gross sales. Among our metalforming members with products liability coverage, premiums represent 1.8% of sales, or an average of $147,200. This percentage is even higher—2.3% and 2.9%—for members with sales of $7.5–$15 million and $2.5–$5 million, respectively.

Our metalcutting members pay an average premium of $139,200, 7,226% increase in just eight years.

Many of our members have only nominal products liability insurance. The combination of their annual premiums and deductibles nearly equals (and in some cases surpasses) the ceiling of their primary coverage. These companies have purchased this paper insurance to satisfy customers' sales requirements or to qualify for umbrella coverage, which protects the insured from catastrophic claims which threaten their assets.

Still an appalling 21% of member machine tool builders with annual sales in excess of $2.5 million are unable to secure umbrella coverage which, when obtainable, costs 238% more than it did in 1976.

Twenty-eight percent of our members with primary coverage responding to our survey reported average deductibles of $85,000, compared to $27,000 in 1975. Practically speaking, this means over one-fourth of our members with so-called primary coverage are self-insured for the first $85,400 of every claim against them.

The foregoing grim statistics lead to the natural conclusion that the machine tool industry must be losing massive damage suits on a regular basis. Although our industry is presently defending a plethora of lawsiuts, its court room record is quite impressive. In fact, of 723 closed claims reported in 1976 and 1978 surveys, only 12% actually reached trial; and, of these, our members won 75%.

In other words, only 3% of the total number of products liability claims against our members have resulted in judgment substantially in excess of the plaintiff's workers' compensation lien.

Even more disturbing is the fact that one-half of our members' lawsuits involve machine tools over 20 years old. Moreover, in only 13% of these workplace, product-related accidents could a feasible case be made that they were caused by mechanical failure.

Fifty-eight percent of the claimants in these suits had been on the job less than six months. Sixty-five percent had received improper training from their employers of whom 65% had failed to guard their machine tools properly.

What these statistics show is that many machine tool builders are innocent third-party defendants in lawsuits involving injuries to novice, ill-trained machine tool operators whose employers, insulated by workers' compensation benefits, have provided them with unguarded, over-aged machine tools.

It is the quantity of the products liability suits—not the quality of our products—which have persuaded many products liability insurers either to abandon the field or to charge astronomical premiums unrelated to the insured's claims experience. Defense costs equalling 35¢ for every dollar paid out rather than actual judgments are spooking products liability carriers.

Unfortunately the present Internal Revenue Code gives the underinsured machine tool builder who is considering self-insuring or who is forced to "go bare" little solace. Section 165 of the 1954 Code permits a business to deduct a loss from current earnings only after a loss has been suffered. This means that only after-tax dollars may go into products liability reserve funds. Needless to say, most machine tool builders, whose margin of profit is low, and for whom liquidity to purchase new capital goods is always a problem, cannot afford to establish these funds.

To compound the machine tool builder's insurance dilemma, Sections 531–33 and 537 of the Tax Code provide for an accumulated earnings tax in addition to federal income tax. Products liability reserves might well be subject to this additional burden if the IRS agency decides that they are not within the "reasonable needs of a business" as those "reasonably anticipated." The vagueness of this statute places the self-insurer in double jeopardy from both the federal income tax and accumulated earnings tax.

Any legislative efforts to ameliorate the self-insurer's plight must contain three tax revisions. The first revision would be a change in the Tax Code permitting the establishment of products liability reserves with pre-tax dollars. The second revision would be a provision in the Tax Code excluding products liability reserve funds set up in accordance with the law from the accumulated earnings

taxes. The third is another change in Tax Code creating a ten-year carryback period for product liability losses. S. 3049 and the Administration's carryback proposal, if enacted together, would accomplish these important tax steps in the resolution of the product liability crisis facing much of America's capital goods industry.

In developing an adequate and acceptable product liability self-insurance program two considerations should be paramount. The first is to provide protection to those companies with severe product liability insurance problems the best protection. The second is to establish safeguards to prevent misuse and tax avoidance.

S. 3049 provides both a rational test for defining companies with a severe product liability insurance problem and a means of circumscribing the use of funded product liability reserves.

S. 3049 makes a distinction between companies with a severe product liability insurance problem and those with a lesser problem. The former are defined as companies which cannot obtain a premium quotation for product liability insurance with coverage of up to $1,000,000 or whose lowest quotation for such insurance exceeds 3% of gross sales. These companies qualifying as businesses with a severe product liability insurance problem could reserve an amount which in no event could not exceed $100,000 per taxable year.

Companies wishing to establish a products liability reserve fund, but not qualifying as having a severe product liability insurance problem could set aside no more than $25,000 per taxable year.

Critics of product liability self-insurance legislation, claim such legislation would have a substantial adverse revenue impact. However, reputable sources estimate S. 3049's first-year cost at $133 million, tapering to about $26 million by the fifth year. Moreover, approximately three-fourths of the first-year revenue loss is attributable to those companies whose less severe product liability insurance problems qualify them only for the $25,000 deduction.

S. 3049 limits the use of product liability funded reserves to the payment of product liability investigation, litigation, and actual claims. Its safeguarding mechanism provides that funded reserves used for other purposes will be included as taxable income to the taxpayer for the taxable year in which such use commences, and an additional tax of 50% would be levied on these funds.

The Administration estimates its 10-year carryback proposal would cost $10 million a year. This carryback provision for product liability losses, standing alone, primarily aids those companies with catastrophic product liability losses, which cannot be completely written off within the current three-year period. It affords no practical relief to a profitable company which has recurrent, but irregularly timed product liability defense and/or settlement costs.

Moreover, an increasing practice is for customers to require that vendors have product liability coverage before the completion of a proposed sale. The funded product liability reserve may meet this requirement; the carryback proposal clearly does not.

Unfortunately, the Administration rejected S. 3049's self-insurance approach in favor of its 10-year carryback proposal. We do not see why each solution must be mutually exclusive. Why not give the businessman the opportunity to prudently reserve against smaller liability losses with tax deductible dollars (under S. 3049) and to carryback catastrophic losses over a ten-year period (under the Administration's proposal).

Present law exacts a penalty on prudence. Moreover, it does not provide equitable tax treatment of expenditures which are clearly and unmistakably business related.

A case can be made for lowering the 3% threshold in defining severe product liability insurance problems and eliminating the deduction for those without a severe product liability problem. Your Committee may also wish to give consideration to increasing the $100,000 ceiling on contributions to fund reserve. This revision to S. 3049, combined with the Administration's ten-year carryback loss proposal, could be accomplished within the constraints of a first-year revenue loss of about $100 million.

NMTBA is confident that the Finance Committee can devise such a mechanism and include it as part of H.R. 13511, along with the ten-year carryback proposal, at a modest cost. This Committee established a precedent for S. 3049, when, under the leadership of Chairman Long and Senator Hansen it permitted tax deductible self-insurance reserves for Black Lung benefits.

NMTBA cannot overstate the immediate need for a product liability tax relief measure which would alleviate the product liability insurance crisis wreaking havoc with the United States machine tool industry. It is no exaggeration to predict that if no immediate relief is forthcoming, much of America's capital goods industry will be forced to the brink of disaster.

STATEMENT BY DONALD G. BROTZMAN, VICE PRESIDENT, RUBBER MANUFACTURERS ASSOCIATION

I am Donald G. Brotzman, Vice President of the Rubber Manufacturers Association. Our Association today is speaking for almost 200 member companies, with facilities in every state in the Union, manufacturing and distributing 40,000 different rubber products. I am very pleased to have this opportunity to appear before the Subcommitee on Taxation and Debt Management with our comments in connection with the development of legislation to provide a deduction for reserves for payment product liability losses.

The exposure to potential product liability losses has recently become an increasingly significant problem for many segments of American industry, and it shows no indication of a moderating trend. Prompt Congressional action is therefore essential if this exposure is to be kept within manageable bounds. Many of the factors which have created this growing exposure have been well articulated in the recent hearings before the Senate Small Business Committee, in the Final Report of the U.S. Department of Commerce Interagency Task Force on Product Liability and in the Report on Product Liability Insurance submitted by the House Committee on Small Business (H.R. Rep. No. 95-997, March 21, 1978). Surveys conducted among our own members in the 1970 and 1976 confirm the increasing severity of this problem. Of the members responding to both surveys, the average cost per $1,000 of sales in obtaining umbrella coverage increased by more than 400% from 1970-1976.

The Rubber Manufacturers Association believes that action to manage the exposure problem is urgently needed in three principal areas (all of which, in general terms, are supported by the Association):

(1) tort law reform;

(2) risk management through joint industry action and,

(3) federal action to provide a suitable framework for solutions in the private sector.

RMA is working actively to assist industry in responsible action in each of these areas. Within the federal action category, we specifically seek a meaningful tax relief measure encouraging management of the product liability problem by companies whether large or small. Such tax relief legislation should of course be reasonable, as well as meaningful, and safeguards against abuse should be included.

We have carefully reviewed the legislative proposals thus far introduced in the Congress (including S. 1611 and S. 3049 and various bills in the House of Representatives) or suggested by Administration announcement. We commend the sponsors of each proposal for recognizing the need for Congressional action to aid in responsible management of the product liability exposure problem in the private sector. Each proposal reviewed contains elements leading towards a constructive legislative solution, and with the inputs you will receive in these hearings, we believe that truly constructive legislation can result. RMA is ready to assist fully toward that end.

At this time, RMA is here to endorse legislation providing essential tax relief through deductible contributions for self-insurance against product liability risks. Such an approach should be effective, while also embodying the sound general legislative characteristics of simplicity, clarity, and flexibility from both operational and regulatory standpoints. In this connection, I shall also discuss reasonable safeguards to assure use of the reserve funds in a manner consistent with the statutory purpose and the tax benefits allowed, as well as the desirability of using a tax-exempt trust to facilitate prompt accumulation of the product liability reserves needed.

A. Amounts reasonably set aside as a product liability reserve should be deductible

The reason why the product liability problem is before the Subcommittee is easily stated: Conventional insurance has become increasingly expensive and

increasingly difficult to obtain. Even if obtainable and (comparatively) affordable, the cost of insurance often bears no apparent relation to loss experience. Self insurance is a natural response, but self insurance reserves have usually been nondeductible, and, unless the sums set aside are deductible, they may very well prove inadequate.[1]

The proposals under consideration before the Congress generally recognize the need for responsible self-help and would, with the single exception just noted, allow a deduction for funding a product liability reserve. While the mechanics of the bills vary, the underlying principle of a deduction in exchange for a funded reserve is sound, and we endorse it.

One variation in the bills is as to the amount deductible, which might either be a specific dollar limitation in the statute or a more general statutory standard to be filled in by Treasury Regulations. We believe that there is merit in each approach. When the statute includes specific dollar or percentage limitations, both taxpayers and government benefit from the resulting certainly and ease of administration. Where specific amounts may be inadequate to specific needs or may otherwise prove arbitrary, more general standard can be helpful in retaining reasonableness and flexibility, without the need for repeated legislative attention.

We would therefore be inclined to use both a specific standard and a supplemental general standard. The specific standard might be conservatively stated, in order to provide an easily administered minimum. The general standard might include a "facts and circumstances" test administered by the Treasury Department, and considering (among other things) the availability and cost of conventional insurance, loss experience of the taxpayer or others manufacturing comparable products, and the potential magnitude of losses if sustained.

Conditions for the making of deductible contributions should also be reasonable. For example, to the extent that the amount of an allowable reserve deduction is based upon sales or other financial information, some period after the end of the taxable year should be allowed to complete the calculations and then make the deductible contribution. The bills vary on this point, but perhaps, by analogy to other similar rules in the Internal Revenue Code, the deduction might be allowed to relate back to the preceding year if made before the due date for filing returns (including extensions thereof).

The amount deductible will naturally be dependent, at least in part, upon the permissible hazards covered. For the most part, the definitions of product liability do not appear to vary materially from bill to bill. However, from our reading, it is not clear to us that all of the definitions would apply to consequential damages arising from product recalls. In the case, hypothetically, of a manufacturer supplying a defective $10 part included in a $6,000 automobile, the consequences of a mandated automobile recall might be well nigh disastrous, unless covered by the legislation now under consideration. We urge the Congres to make it clear that such situations will be included in the definition of permissible product liability hazards for all parties affected. In addition, we note that some of the bills include service-related operations within the definition, which we consider equitable if relief is provided for manufactured products. This extension would also eliminate potential administrative difficulties, which might be involved if it were necessary to distinguish as a cause for liability the original manufactured product and some subsequent repair service.

B. Use of product liability reserve funds should be limited, consistent with the reserve's purpose and the tax benefits allowed

Since the bills would allow a deduction for amounts in effect retained on hand to meet a contingent future business need, it is only reasonable that there be some limitations upon use of the funds set aside. All of the proposals contain such limitations, including the requirement that the funds be held by a separate trustee (or a separate corporation, one example of which is considered more fully below). We endorse the trust fund (or separate corporation) concept, as appropriate in formally separating product liability reserves from a taxpayer's general funds and as helpful in assuring that accurate records are available for government review.

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[1] Such inadequacy, unfortunately, would apparently continue if a recent Treasury Department proposal (forwarded August 1, 1978 by Assistant Secretary Lubick to Chairman Ullman) were adopted. Since this proposal would allow only an extended operating loss carryback, there would be no current deduction or practicable incentive for current funding. In the event of a major loss, then, a corporate taxpayer might recover up to 48% (at present rates) of the loss from the government, but would be left unfunded for the 52% balance. Thus, while we appreciate the Administration's concern about product liability problems, we do not regard the August 1 proposal, standing alone, as a fully adequate response to these problems.

Another legitimate concern, reflected in various ways in the bills, is that a taxpayer not find it convenient to use the trust as a tax shelter by making a deductible contribution in a profitable year, and then making an inappropriate withdrawal of the deducted funds in a later year when he has offsetting business losses. This issue might be handled in a number of ways, ranging from total ban on any use other than satisfaction of product liability claims, to simple penalties of greater or lesser severity, to complex regulatory arrangements requiring subjective judgments as to "proper" withdrawals.

We would suggest, for the Subcommittee's consideration, that it should be possible to provide disincentives for abuse without either undue complexity or undue harshness. There should, we believe, be the possibility of a reasonable balancing of interests. The tendency should be for the taxpayer to keep the trust funds available for their intended purposes. On the other hand, if the need for the funds is thereafter eliminated, it may make no economic sense to force excess funds either to remain permanently unproductive in a trust or to incur harsh penalties upon withdrawal. Several examples come to mind where product liability reserves might cease to be necessary. A high exposure product or line of business might be discontinued or sold. Similarly, changes in product liability law or reductions in the cost of available insurance might obviate the need for self insurance.

C. Use of the tax-exempt trust should encourage prompt accumulation of needed product liability reserves

In general, the Association endorses the concept of (1) a deduction for contributions and (2) a tax-exempt trust, because this combination should facilitate the most rapid accumulation of the funds needed to cover product liability risks. Effective legislation to these ends could take a number of different forms, but whatever form is ultimately adopted, it should provide the essential tax relief by allowing a deduction for contributions for self insurance against product liability risks.

Of the alternative approaches available, we favor the tax-exempt trust in principle but we are also concerned about the regulatory complexities sometimes associated with tax-exempt trusts. Due to the possibly onerous burden placed on the taxpayer by incidental regulation and by application of excise taxes as penalties, we suggest that the Committee give careful study to the use of simpler alternatives to the complex (and severely punitive) excise tax restrictions which have evolved in recent legislation. The regulatory framework for the tax-exempt trust has developed in several different settings in recent years: charitable private foundations in 1969, qualified employee benefit trusts (and, to a lesser degree, individual retirement accounts) in 1974, and mine workers' black lung benefit trusts in 1978. In the case of those product liability bills which appear to be patterned on such prior legislation, we note that 70% of the printed pages are devoted to rules for the application of the various excise taxes. Such complexities could make the intended relief illusory.

We think it is possible to simplify such restrictions without diminishing their overall effectiveness. For example, withdrawals of excess funds which gave rise to no deduction when contributed should require no elaborate regulation. Investments might be somewhat controlled but improper investments might be deemed a constructive distribution, rather than being made subject to the enormously confusing excise tax rules on acts of self dealing. We do not see, incidentally, why it should be necessary to limit investments to comparatively low yield government or bank securities, although curtailment of investments in the taxpayer's own securities would seem appropriate.

There is another reason why a simpler approach may commend itself to the Subcommittee: the circumstances are significantly different from other areas where tax-exempt trusts and the accompanying retinue of excise taxes have been found necessary. For example, in tax-exempt trusts dealing with private foundations, employee plans, and black lung benefits, the intended class of beneficiaries can be readily identified and the eventual application of funds is usually certain. In the product liability area, however, tax-exempt trusts are essentially an alternative mechanism for funding a regular business cost which might otherwise be difficult to finance. As such, the need for inclusion of restraints designed to insure a high standard of fiduciary conduct is perhaps less clear than where someone else's funds are being held.

To the extent it appears to the Committee that excise tax restrictions cannot be simplified under the tax-exempt trust format, then the Association urges it

to give careful study to the alternative of a taxable trusteed reserve account. Removal of the feature of automatic tax-free build-up of income in a tax-exempt trust should further reduce the need for severe regulatory provisions, without necessarily slowing the rate at which product liability reserves accumulate. To achieve this result, the economic effect of trust income taxes could be offset, in appropriate instances, by defining deductible contributions to include retained earnings of the trust fund where needed to self-insure against demonstrated product liability risks.

D. Consideration should be given to allowing captive insurers to meet product liability needs

The Commerce Department proposal (introduced in the Senate as S. 3049 and in the House as H.R. 12429) would also expressly authorize, as one alternative, deductions for contributions to domestic captive insurance companies for insurance of product liability risks. Apart from the fact that such arrangements may be permissible under present law, the business nature of the product liability transactions may make segregation into a separate corporation a sufficient earmarking for the limited purposes involved.

The limitation to domestic captives may be unnecessary, however, in view of the taxation under Subpart F of the Internal Revenue Code (as recently tightened) of a controlled foreign corporation's income from insurance of U.S. risks. The foreign captive may be more suitable than a domestic one, for wholly nontax reasons, including state regulatory requirements which may be costly and unnecessary, given the limited functions which may be undertaken by the captive.

E. CONCLUSION

To sum up briefly, we agree that there is a significant problem urgently requiring Congressional action. We believe that such legislation should encourage responsible action to manage the problem in the private sector. We commend all of those in the Congress who have introduced bills or otherwise brought the matter to the present stage. Finally, we support and urge enactment of tax legislation allowing a deduction for reasonable contributions to a tax-exempt product liability trust fund, and we hope that such legislation will be simple and easy to administer.

STATEMENT OF THE MACHINERY AND ALLIED PRODUCTS INSTITUTE

SUMMARY

In capsule, the MAPI statement to the Taxation and Debt Management Subcommittee of the Senate Finance Committee concerning S. 1611 and S. 3049, takes the following positions:

In general

1. The products liability problem, as recently noted by the present Administration, is a "national problem" which, although having its greatest impact on smaller companies, adversely affects all manufacturers of capital goods.
2. MAPI believes that the problem not only continues unabated, but is, in fact, increasing in dimension as shown in a recent telex survey of 62 major U.S. manufacturers.
3. We commend the Commerce Department and the Interagency Task Force on Product Liability for their comprehensive study of products liability, and we support their findings that suggest the need for a broad approach to alleviating the problem.
4. While the Administration, in proposing an extension of the current three-year net operating loss carryback to ten years for products liability-related net operating losses, where those losses cannot be absorbed under the current three-year program, is headed in the right direction, we think that the proposal has little merit and should be rejected.
5. Tax deductibility for contributions to a self-insurance reserve or trust for payment of products liability losses is a very necessary, short-range solution to the general problem.
6. A significant test of member company sentiment suggests that an adequate tax-deductible, self-insurance program, if enacted, would be used.

More specifically

7. We commend Senators Culver and Nelson for their thoughtful efforts in developing a tax-deductible, self-insurance program, such as those embodied in S. 1611 and S. 3049. However, we fell both measures are deficient in certain respects and we suggest the following:

a. Amend the Internal Revenue Code to permit by election of the taxpayer creation of a tax-exempt trust or loss reserve account for the payment of products liability claims and related expenses.

b. Authority for the creation of any such trust or reserve should require cash contributions and should expressly exempt from taxation contributions to, and income from, the trust. Moreover, appropriate language should also expressly exempt from current taxation under any theory payments made by the trust or from the reserve on behalf of the corporation for products liability-related purposes.

c. As for the measure of tax deductibility in any year, we tend to favor the estimated cost of products liability insurance. Recognizing the difficulty of applying this standard, the Subcommittee may wish to consider conditioning tax deductibility upon an independent actuarial certification—submitted to the IRS perhaps every three years—as to the proper amount for the individual taxpayer.

d. To avoid unnecessarily narrow administrative interpretations of statutory language, we believe any enactment of this type, or the legislative history, should clearly indicate—without general limitation—the kinds of costs for which trust or reserve funds may properly be expended.

e. If a tax-exempt trust is elected over a reserve fund, a provision should be made for changing the maximum level of any authorized trust, as circumstances leading to creation of the trust may change, subject to the concurrence of the Internal Revenue Service under such regulations as it may prescribe.

f. Finally, acknowledging the realities of both politics and insurance availability to which we have already referred, we believe accumulations under any such trust or reserve fund should have some maximum permissible overall level. We think it should be not less than $2 million and probably as much as $5 million, with the exact amount in any case—within the maximum—keyed to some multiple of the approved annual contribution to the trust or reserve.

Statement of the Machinery and Allied Products Institute

Mr. Chairman and members of the Subcommittee, we greatly appreciate this opportunity to comment on S. 1611, sponsored by Senator Culver, and S. 3049, the proposed "Product Liability Self-Insurance Act of 1978," sponsored by Senators Culver and Nelson. The former measure would permit tax deductions for contributions to products liability loss reserves for the payment of products liability claims and related costs. The latter measure, S. 3049, would also permit tax deductions for amounts paid into products liability loss reserves and, in addition, would permit deductions for amounts paid to captive insurers for products liability an related purposes.

The Machinery and Allied Products Institute is a national organization of capital goods and allied industrial product manufacturers. Our interests in products liability dates from 1960; that interest has grown steadily in the intervening years and, with the general objective of informing industry of this growing problem, has resulted in the publication of three full-length books, based on major conferences, a series of memoranda, and, more recently, participation in three congressional hearings on the subject.

Our statement is divided into four parts:

1. The nature and scope of the problem.
2. Increasing governmental interest.
3. The proposals before the Subcommittee.
4. The Institute's recommendations.

The Nature and Scope of the Problem

In the light of all that has gone before, it seems unneecessary to prove, or even to discuss at length, the existence of the products liability problem. However, in order to place our later discussion and particularly our recommendations in the broad perspective which any view of this very complex subject requires,

it may be useful to sketch in broad outline certain of the background developments which have brought us here.

As noted earlier, we have followed the course of products liability in this country for nearly 18 years. In that span of time—thanks largely to a fundamental change in tort law affecting products liability—it has become a national problem of major dimensions. Although global statistics on the subject are unreliable, or nonexistent—and, in fact, the absence of statistics upon which to base insurance rates is a significant part of the problem—it is now generally accepted that products liability has assumed something approaching the proportions of a crisis. Indeed, the Administration recently described it as a "national problem" at a press conference outlining its proposed relief measure.

Two years ago MAPI surveyed the capital goods industries on this matter. Some 210 member companies responded. The collective experience reflected in response to the survey indicated a sharp rise in both the number and amount of products liability claims over the preceding decade and a corresponding—or more than corresponding—increase in products liability insurance premiums.

In July of this year we undertook to update the central conclusions of the earlier survey by querying 62 members of the MAPI Products Liability Council who represent major U.S. manufacturers. Responses were received from 95 percent (59) of the companies surveyed. A copy of the questionnaire is attached to this statement as Exhibit A. Highlights of the survey responses include the following:

1. 81 percent of the companies responding indicated that their products liability "problem" has increased during the last two years. Another 17 percent indicated that the problem has remained constant and unabated during the same period of time. Only 2 percent indicated that their products liability problem has diminished.

2. Those reporting an increased problem (47 companies) attributed the increase to the following factors.

a. Increased number of claims—27 responses (25 percent).
b. Increased amount of claims—31 responses (28 percent).
c. Increased insurance costs—40 responses (37 percent).
d. Unavailability of insurance—11 responses (10 percent).

Thus, the 47 companies reporting an increased products liability problem attributed the increase, on an average, to more than two of the four factors identified above, suggesting that products liability increases are caused by multiple factors and that any single "solution" is likely to be deficient.

3. The survey inquired by what percentage insurance costs have increased in the recent past. Among those indicating increases the responses vary dramatically from less than one percent to 1,300 percent in the last two years, and from less than one percent to 215 percent within the last year.[1] Of the companies reporting higher insurance costs, 16 (34 percent) indicated increases of 100 percent or higher during the last two years; and 5 companies (14 percent of those able to respond)[2] showed increases within the last year of 50 percent or greater.

4. The survey inquired as to the acceptability and usefulness of a change in the Internal Revenue Code to provide for tax deductibility of corporate contributions to self-insurance (products liability) reserves. Significantly, 80 percent of the companies responding indicated that if such a provision were enacted they would be likely to establish such a reserve. In addition, 70 percent felt that such a program would be an important factor in helping to alleviate the general products liability problem. The difference between these two figures may be attributed to concern on the part of some companies that such a tax program might hinder or delay substantive tort reform, examination of insurance industry practices as they affect products liability, or other measures necessary to adequately deal with the multi-faceted (see paragraph 2 above) nature of the products liability problem.

In conjunction with the question on the appropriateness of tax deductibility for products liability reserves, Council members were asked to propose appropriate limitations, if any, on such funds. Most companies readily responded with a specific proposal, although some felt that no limitation should apply. The variance in responses was substantial, reflecting differences in corporate size, sales, product types, etc. Nevertheless, a number of respondents suggested a percentage

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[1] Higher percentage rate increases were also reported, but the increases were in policies covering more than products liability and the specific coverage in question could not be broken out.

[2] A number of companies indicated that the information necessary to respond was not yet available.

of sales limitation; the majority in the two to five percent range. One suggestion which was proposed by a number of respondents called for a fund limit based upon the actuarially projected products liability loss for each individual company. This approach may be the most equitable insofar as meeting the needs of a wide range of company types and sizes is concerned. Responses recommending a flat dollar limitation most frequently fell in the $1–2 million range.

INCREASING GOVERNMENTAL INTEREST

Notwithstanding industry's growing concern about products liability over a considerable number of years, it was not until 1976 that the federal government recognized the problem by establishment of the Interagency Task Force on Product Liability under the leadership of the Commerce Department. The Federal Register notice of the Task Force's existence and mission contained this statement: "Preliminary evidence suggests that the number and size of product liability claims have increased substantially in recent years, that premiums for products liability insurance have risen sharply, that many manufacturers are experiencing difficulty in obtaining products liability insurance, and that small businesses have been particularly affected." [3]

This statement, it will be noted, emphasized and reemphasized the insurance aspect of the total problem. Indeed, congressional hearings both before and after the announcement of the Task Force's creation focused particularly upon the unavailability and/or excessive cost of products liability insurance. And it is, of course, insurance—more specifically the need for products liability insurance at reasonable cost—with which at least a portion of these hearings is directly concerned.

We call attention to this administration and legislative preoccupation with insurance simply by way of introducing a point which needs to be made and must not be forgotten. It is, of course, essential to make available to all business products liability insurance at reasonable cost, but it should not be assumed that a response to that need is in any sense a total solution to the products liability problem. More will be needed and this broader scope of the total problem is suggested by the findings set forth in the Final Report of the Interagency Task Force. (It is also suggested by the responses in section 4 of our most recent survey discussed above.)

The Final Report reaffirmed the conclusion of the ealier "Briefing Report" that the products liability problem had three principal causes—liability insurance ratemaking produres, the tort-litigation system, and manufacturing practices. Thus, both the Final Report—which contained no recommendations of governmental action—and the subsequent "Options Paper," circulated by the Commercial Department for review within the executive branch of government, acknowledged the problem to be one much broader than simply that of products liability insurance.

The "Optons Paper" recommended as one of its short-term solutions—the paper also suggested nine long-term solutions—tax deductibility for contributions to self-insurance reserves. (Subsequently, this option was withdrawn and replaced by a Treasury-influenced recommendation that, in lieu of tax deductibility, the current net operating loss carryback provision in the Code be extended from 3 years to 10 years where net operating losses attributable to products liability exceed taxable income for the immediately preceding 3-year period. The extension would be applicable only to products liability losses and related costs.) Even as the Interagency Task Force proceeded with its study, legislative measures were proposed in the Congress, including S. 1611 and later S. 3049, which addressed all aspects of the products liability problem, with the bulk of such proposals addressed to reform of the present tort-litigation system as it affects products liability. Concurrently, there was a considerable number of specific enactments of this character among the several states.

We conclude this portion of our testimony with this observation. The Final Report of the Interagency Task Force, which took 18 months several hundred thousand dollars to complete, is unquestionably the most comprehensive study of the subject yet undertaken. In general, that study confirms that the problem is real and serious and worsening. We suggest that no further study is necessary; what is now required is action.

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[3] *Federal Register*, Sept. 20, 1976, p. 40529.

THE PROPOSALS BEFORE THE SUBCOMMITTEE

The Chairman's statement, published in the *Congressional Record* of Aug. 18, identified among the subjects of this hearing two legislative proposals, S. 1611 and S. 3049, which would authorize tax deductions for contributions to self-insurance reserves created to pay products liability claims and related costs. In addition, S. 3049 would permit deductibility of amounts paid to captive insurers for the same purposes.

The Administration has announced its recommendation, already noted, to amend the Internal Revenue Code to extend in certain situations the net operating loss carryback provision from 3 years to 10 years with the extension to be made applicable only to products liability losses and related expenses. This recommendation is, in effect, a substitute for a Commerce Department recommendation very similar to S. 3049 now before this Subcommittee. Although the Chairman's announcement of these hearings did not include consideration of the present Administration's recommendation in this matter, we take it that the Subcommittee is interested in the proposal and, hence, we have commented thereon in this statement.

Tax deductibility.—We have examined below, with appropriate reference to the bills here involved, important features of any measure which would permit tax deductibility for contributions to a products liability self-insurance reserve.

1. *Creation of the loss reserves.*—Both of the measures here under consideration would authorize the creation of tax-exempt products liability loss reserve accounts by amending section 165 of the Internal Revenue Code of 1954 to provide deductions for payments to a reserve account for the payment of product liability losses. S. 1611 would make deductible "* * * the amount transferred by the taxpayer for the taxable year to his product liability loss reserve account." This does not appear absolutely to require a segregation and hypothecation of actual funds; it suggests rather that the requirements of the measure could be fulfilled by accounting entries and with amounts thus reserved subject to debit by cash payments to cover products liability losses and related expenses.

The Culver and Nelson bill, S. 3049, provides that there would be allowed as a deduction the sum of:

(A) Any amounts transferred by the taxpayer for such taxable year to his product liability loss reserve account, and

(B) Any amounts paid by the taxpayer for such taxable year to a captive insurer with respect to the product liability of the taxpayer.[4]

While the language of Subparagraph (A) is very similar to that of S. 1611, S. 3049 specifically identifies (in section 6) cash and other liquid assets as the necessary form of deductible contributions.

The final legislation should make the matter clear. We suspect that the ultimate disposition of the Subcommittee, especially regarding contributions to captive insurers, may be to require cash contributions inasmuch as they are being equated with the payment of products liability insurance premiums for which tax deductions are, of course, routinely allowed.

Concerning the captive insurer aspect of S. 3049, additional clarification is necessary with regard to the deductibility of payments to an "off-shore" (foreign) captive. Section (9)(D) defines "captive insurer" to mean "any insurer wholly owned or partially owned, directly or indirectly, by the taxpayer which is licensed to provide product liability insurance to the taxpayer under the laws of a State of the United States." Presumably all "off-shore" captives of U.S. companies currently insuring domestic products liability exposures are licensed to do so in states where coverage is placed.

We suspect that the intent of S. 3049 is to exclude, altogether, tax deductibility for payments to "off-shore" captive insurers. Such an approach to deductibility, we believe, does nothing to relieve the products liability problem and unfairly discriminates against those U.S. companies which have already established such captives in an effort to alleviate their own products liability problems. In any event, as indicated above, clarification on the point is needed.

The Institute strongly supports the principle embodied in these two bills and the approach underlying them. Legislative adoption of that principle would—by authorizing tax deductions for contributions to self-insurance reserves—help

[4] It appears, however, that contributions to the capital of a captive would not be deductible.

to place those companies which are unable to obtain products liability insurance coverage at an affordable premium on an equal footing with those companies which can. Moreover, by premitting deductions for premiums paid to captive insurers for such coverage, S. 3049 would encourage their formation and thereby enlarge the market for products liability insurance. Still another virtue of this loss reserve approach is the fact that, by providing substantial relief in the short run, it would make possible the development of a comprehensive long-range program of tort reform which the present situation demands.

2. *The measure of tax deductibility.*—The two bills under consideration differ substantially in their respective measures of deductibility. S. 1611 would permit an annual tax deduction not exceeding the lesser of:

(A) 3 percent of the gross receipts of the taxpayer from the manufacture, importation, distribution or sale of such product, or

(B) The amount which, when added to the balance of the product liability loss reserve account, equals 15 percent of the taxpayer's average yearly gross receipts from the manufacture, importation, sale, lease or distribution of such product for the shorter of:

(i) The period during which the product liability reserve deduction has been taken;

(ii) The five years ending in the taxable year for which the current deduction is taken.

The second measure, S. 3049, would create a two-tier set of limitations on amounts deductible. First, for those taxpayers with a "severe product liability insurance problem," [5] the deduction would be limited to the smallest of:

(i) 5 percent of the gross receipts of the taxpayer for such taxable year from the manufacture, importation, distribution, lease, or sale of such product,

(ii) The amount which, when added to the sum of—

(I) The balance of the taxpayer's product liability loss reserve account, and

(II) The net contributions [6] of the taxpayer to his captive insurer, if any, equals 15 percent of the taxpayer's average yearly gross receipts from the manufacture, importation, distribution, or sale of such product during the base period, or

(iii) $100,000.

For taxpayers which do not qualify as having a "severe product liability insurance problem," these three benchmarks are set at 2 percent, 10 percent, and $25,000, respectively, and again the deduction is limited to the smallest of the three.

We are inclined to believe that either approach mav cause problems. S. 1611's measuring stick of a percentage of sales dollars might well be easier to administer; however, its overall limitation of 15 percent of average gross receipts over a five-year period would result in authorization for a reserve of such magnitude as to make it impossible of adoption by the Congress for political reasons.

On the other hand, S. 3049's limitations on deductibility are designed to avoid abuse by "large companies," or, for that matter, any benefit to such companies. In so doing, these limitations make the products liability loss reserve almost worthless for all but the smallest companies. Let us consider the case of an imaginary company "A" which sells $5 billion annually of a certain type of machinery—which we assume to be a "yearly average." Assuming a "severe product liability insurance problem," 5 percent of the company's gross receipts is $250 million and 15 percent of average yearly gross receipts is $750 million. Yet its tax deduction for contributions to a self-insurance reserve or in premiums to a captive insurer for this coverage is $100,000. If Company "A" does not have a "severe product liability insurance problem," the equivalent amounts are $100 million, $500 million, and $25.000 with the last being the "smallest" and thus the limitation.

Large and medium-sized companies also have experienced extraordinary increases in products liability insurance premiums and/or the acceptance by neces-

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[5] A taxpayer would qualify as having a severe product liability insurance problem for a taxable year if for such taxable year either:

"(A) the taxpayer is unable to obtain a premium quotation for product liability insurance, with coverage of up to $1,000,000, from any insurer other than a captive insurer; or

(B) the lowest insurance premium quotation for product liability insurance, with coverage of up to $1,000,000, obtained by the taxpayer was equal to more than 3 percent of the gross receipts of the taxpayer for such taxable year."

[6] "Net contributions" is defined as "the sum of all premiums paid by the taxpayer to his captive insurer for product liability insurance, *less* all amounts paid by his captive insurer for claims against the taxpayer * * *." [Emphasis added.]

sity of large deductibles. Obviously, a company with such an exposure as we have just hypothesized cannot adequately protect itself by the reservation of such relatively modest amounts as $100,000 or $25,000, with the amount depending on the severity of the company's problem. Everyone would agree that abuse must be avoided, but we think that in straining for that result here the draftsmen of the bill have destroyed its value for large numbers of companies now seriously affected by products liability.

This same discriminatory attitude against large and medium-sized companies is evident in section (i) (3) of S. 3049 which would disallow deductions "* * * for any product liability loss paid or incurred by the taxpayer during the taxable year except to the extent that the aggregate amount of such losses during such year exceeds the sum of—

(A) The amount in the product liability loss reserve account of the taxpayer at the beginning of such taxable year, plus

(B) The aggregate amount of payments by the taxpayer to such account within the taxable year which are allowable as a deduction under Paragraph 1 [the paragraph authorizing tax exempt product liability loss reserve accounts]."

We readily agree that a taxpayer should not be allowed a double deduction under the present Code section 165(a) and the proposed section 165(i). However, we strongly object, as stated above, to the intent to limit the tax deferral benefits of the proposed new section to smaller companies.

Whether Congress adopts a scheme like this one which is so skewed against the medium-sized or large company or rewrites this proposal to make it useful for all types of companies, the revenue loss to Treasury will be about the same. In short, a company will take the deduction either in the form of a contribution to a products liability loss reserve or as a casualty loss upon occurrence. However, to the extent that companies are thus forced to postpone the deduction until an actual loss is incurred they continue at a disadvantage vis-a-vis those companies which can obtain full insurance coverage at a reasonable price and deduct the premium cost currently.

Let us remind ourselves of a fact that we think is significant to the general discussion. Self-insurance for products liability through the medium of tax deductibility will not, and should not, be expected in the vast majority of cases to cover the *total* risk of the company involved. Indeed, the service marketed by the commercial insurance industry is protection from the financial consequences of catastrophic loss. In more practical terms the insurance industry, which for some years has been "running scared" on products liability, has virtually abolished "first dollar" insurance through exorbitant premiums or by insisting upon very large deductibles or policy holder "retentions." Notwithstanding this, most companies with whose situations we are familiar have some threshold figure—say $500,000 or $1 million—above which they have obtained successive "layers" of excess insurance coverage to protect against catastrophic loss. The point is that there now exists for many if not most companies a "bare spot" from the first dollar of products liability loss up to the threshold amount where excess coverage cuts in. To obtain excess coverage, the insured company frequently must provide the insurance carrier with reassurance (sometimes including bonding) that primary exposures—the "bare spot"—are adequately covered. There is, of course, the further and very substantial cost of investigation, litigation, etc., which may or may not be covered by products liability insurance. It is toward the coverage of this "bare spot" that any tax deductibility of the type here contemplated should be directed and where, we think, it could be of the greatest benefit to American industry.

3. *The tax exempt status of the loss reserve.*—Without detailing the separate provisions of the bills now under consideration, let us summarize briefly what we believe any bill finally approved *should* include with regard to the tax status of the products liability loss reserve. First, not only contributions to the fund but the income thereof should be made expressly tax exempt. Equally important, any such measure should exempt from current taxation payments made from the loss reserve account to cover products liability losses and related costs. That is to say, if payments made from the account were to be treated as income (discharge of indebtedness income under Code section 61) and currently taxed to the corporation, there would be little ultimate advantage in the adoption of such a proposal. We are pleased to see that section (i) (13) of S. 3049 recognizes this potential problem and provides the necessary protective language. As far as we are aware, it is the only bill currently under consideration in either the House or Senate that specifically addresses this issue.

4. *Uses of the loss reserve.*—While recognizing the complexity of products liability and the consequent difficulty in defining the term, we nevertheless feel that the definitions of "product liability" in both section (i)(6)(A) of S. 1611 and in section (i)(9)(A) of S. 3049 are inadequate and unclear. First, they are both limited to damages arising out of "physical injuries." Products liability suits may well seek compensation for emotional distress, loss of earnings, loss of product use, etc., funding for which *may* not be deductible under some interpretations of the present definition; a precise determination is impossible due to the verbosity of the definition. All such "non-physical" injury compensations constitute potential losses which a manufacturer must insure against, and should therefore be included in the definition of "product liability" upon which both bills rest.

Secondly, we are uncertain whether "services," the provision of which may lead to "product liability," are included within the definitions. If "services" are intended to be included under "operations," that intent is not clear—especially when read in conjunction with "abandoned." This possible second limitation of the definitions is also inappropriate for the reasons stated above. Consistent with the purpose and intent of the proposed bill, we see no reason to limit the definitions as stated and recommend that, as a minimum, the definitions be restated in clear and precise language.[7]

The Administration's proposal.—We are pleased to note, as mentioned above, the recent public acknowledgement by the Administration that "product liability is a national problem." Moreover, we endorse—with some reservations—the Administration's longer range plans, as announced by Secretary Kreps, for developing general solutions to the products liability problem.

However, we do not endorse—in fact we strongly oppose—the proposal to amend the Internal Revenue Code to extend in certain situations to 10 years the carryback period for net operating losses attributable to products liability losses and related costs. Although not yet cast in the form of a specific legislative measure, one may suppose that this Administration proposal will in due course be introduced in the Congress. Because it has been offered as a substitute for tax deductibility we have thought it useful to discuss it in conjunction with the bills here under consideration. According to the Commerce Department background paper of July 20, 1978:

Because of cost factors and concerns about a questionable precedent, the Administration has endorsed the loss carryback proposal rather than a proposal which would have permitted businesses current tax deductions for contributions to product liability self-insurance trusts. The Administration believes that the carryback is simpler, both for affected taxpayers and the Internal Revenue Service. It will provide the same benefits, other than deferral of taxes, as a current tax deduction for contributions to a self-insurance trust.

Let us examine the Administration's case for its proposal item-by-item.

As for "cost factors," a Treasury spokesman at the July 20 Commerce Department press conference estimated that the rejected Commerce Department proposal would cost $600 million in revenue over a five-year period. This estimate of revenue loss appears to disregard altogether current reductions in revenue resulting from deductions for uninsured products liability losses and related costs. Although it would be no more than an estimate—as is the Treasury figure, for that matter—it is quite possible that revenue losses from this source could equal or even exceed those resulting from tax deductibility for contributions to self-insurance reserves. The only significant difference between these two kinds of revenue losses would be in the matter of timing.

Now let us consider the problem of a "questionable precedent." It is not as likely that this proposal to extend the carryback period—to accommodate a single purpose and no other—might also create a precedent for future reference? We recognize the importance of precedent and agree that this possibility must be considered. We suggest, however, that Treasury has given insufficient consideration to the unprecedented character of the products liability crisis.

Would it be simpler? Perhaps. But do we want a solution that is simple or one that is effective? The question answers itself.

And will it "* * * provide the same benefits"? Almost certainly not, in our judgment. Under the Administration's proposal (as under the present Code), a

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[7] For instance, there is no need to identify any specific legal basis for a products liability cause of action (negligence, etc.). Indeed, the effect of such language seems to be exclusionary and may potentially render the definition obsolete if new theories of recovery are developed.

prudent manufacturer is *discouraged*, tax-wise, from setting aside funds necessary for prompt and adequate payment of judgments and settlements which are intended to provide relief and restitution to injured consumers. Under this proposal injured parties may well find themselves seeking monetary damages from companies which have no choice but to elect bankruptcy.

As provided in the Administration's proposal, a company suffering products liability losses could file amended returns for the preceding 10 years where a three-year carryback results in excess products liability-related net operating losses. However, such a company could recoup such losses only if it has been profitable and had paid taxes in the years to which amended returns apply. Suppose the company is a new one? Suppose it reported low, or no, profits in the prior 10-year period? Are we to understand that a company with a $1 million profit from operations and a $1,005,000 products liability loss can take only $5,000 as a net operating loss carryback? Such a system requires uninsured small companies, in effect, to absorb totally the financial consequences of a catastrophe, thereby discriminating against them in favor of large corporations, which can more readily obtain excess coverage. Furthermore, as mentioned above, where a small company's ability to secure excess insurance coverage is contingent upon proof of adequate financial responsibility in the primary (first-dollar) layer, the Administration's proposal offers little if any assistance.

Moreover, the Administration's proposal would be equally useless at the other end of the industrial scale. In the case of larger companies, products liability losses will rarely equal profits for the year. Thus, there would be no net operating loss, no carryback, and no offsetting refund. But there would be substantial revenue loss—the Treasury's principal concern, we think—as products liability claims and expenses paid directly by the corporation through self-insurance are taken as tax deductions.

To sum up, the Administration proposal would assist far fewer companies than would the tax-deductible loss reserve approach of both S. 1611 and S. 3049 and would, accordingly, represent a far less effective response to the increasingly serious problem of products liability. We think it should be rejected.

OUR RECOMMENDATIONS

In the course of the preceding discussion we have indicated, both explicitly and implicitly, the general direction of our recommendations for legislative action. Our conclusions and recommendations are summarized below.

1. Tax deductibility for contributions to a self-insurance reserve or trust for payment of products liability losses is a very necessary, short-range solution to the general problem.

2. A significant test of member company sentiment, as outlined heretofore, suggests that a tax-deductible, self-insurance program, if enacted, would be used.

3. We think the Administration proposal to extend the net operating loss carryback provision for a maximum of 10 years in certain situations for products liability losses has little merit and should be rejected.

4. To effectuate tax deductibility we suggest the following:

a. Amend the Internal Revenue Code to permit by election of the taxpayer creation of a tax-exempt trust or loss reserve account for the payment of products liability claims and related expenses.

b. Authority for the creation of any such trust or reserve should require cash contributions and should expressly exempt from taxation contributions to, and income from, the trust. Moreover, appropriate language should also expressly exempt from current taxation under any theory payments made by the trust or from the reserve on behalf of the corporation for products liability-related purposes.

c. As for the measure of tax deductibility in any year, we tend to favor the estimated cost of products liability insurance. Recognizing the difficulty of applying this standard, the Subcommittee may wish to consider conditioning tax deductibility upon an independent actuarial certification—submitted to the IRS perhaps every three years—as to the proper amount for the individual taxpayer.

d. To avoid unnecessarily narrow administrative interpretations of statutory language, we believe any enactment of this type, or the legislative history, should clearly indicate—without general limitation—the kinds of costs for which trust or reserve funds may properly be expended.

e. If a tax-exempt trust is elected over a reserve fund, a provision should be made for changing the maximum level of any authorized trust, as circumstances leading to creation of the trust may change, subject to the concurrence of the Internal Revenue Service under such regulations as it may prescribe.

f. Finally, acknowledging the realities of both politics and insurance availability to which we have already referred, we believe accumulations under any such trust or reserve fund should have some maximum permissible overall level. We think it should be not less than $2 million and probably as much as $5 million, with the exact amount in any case—within the maximum—keyed to some multiple of the approved annual contribution to the trust or reserve.

This concludes our statement, and we express our sense of appreciation at being invited to testify before this Subcommittee on this important aspect of the products liability problem. We shall be pleased to answer any questions the Subcommittee may have.

EXHIBIT A.—TELEX QUESTIONNAIRE SENT TO MEMBERS OF THE MAPI PRODUCTS LIABILITY COUNCIL ON JUNE 19, 1978

1. Since publication of the MAPI survey in August 1976, on the basis of your company's experience has the products liability problem—

(A) Increased .... Yes No
(B) Decreased .... Yes No
(C) Continued at Same Level .... Yes No

2. If the problem has increased, was this because of—

(A) Increased Number of Claims .... Yes No
(B) Increased Amount of Claims .... Yes No
(C) Increased Insurance Costs .... Yes No
(D) Unavailability of Insurance .... Yes No
(E) Other Reasons (Please Identify and Explain).

3. If insurance costs have increased in the recent past, by what percentage have they increased—

(A) Since August 1976?
(B) In the Past Year?

Yes No

4. If corporate contributions to self-insurance reserves were made tax deductible under a practicable plan, would you be likely to establish such a reserve?

(B) In your opinion, would such a program help to alleviate the general problem?

Yes No

(C) Assuming the need for a "cap," what dollar or other limitations on any such fund would be appropriate and adequate to ensure its usefulness?

MACHINERY AND ALLIED PRODUCTS INSTITUTE,
Washington, D.C., August 31, 1978.

Senator HARRY F. BYRD,
Chairman, Subcommittee on Taxation and Debt Management,
Senate Committee on Finance,
Washington, D.C.

DEAR SENATOR BYRD: On Monday, August 28, I appeared as a representative of the Machinery and Allied Products Institute before this Subcommittee in connection with its consideration of S. 1611 and S. 3049. These bills would authorize—by differing measures—tax deductions for contributions to self-insurance reserves (trusts) for the payment of products liability claims and related costs. In addition to oral testimony presented on that occasion, we have submitted for the record an extended written statement of the Institute's views on this very important subject.

Of the seven witnesses listed in the Subcommittee's announcement of the "Panel on Products Liability," six supported the principle of tax deductibility and emphasized the need for immediate relief in this area. Only one announced witness, the representative of the American Insurance Association (AIA), opposed the principle. One additional and unannounced witness, the Acting Deputy Assistant Secretary of the Treasury (Tax Legislation), also opposed legislation

to grant tax deductibility for this purpose. Although we questioned certain of the conclusions presented in the testimony of these two witnesses in the course of the recent public hearing, given the very crowded schedule of the Subcommittee, we deemed it inappropriate to challenge in any detail such testimony at that time. However, since the hearing we have examined with care the principal statements of both witnesses and our doubts have increased. Both contain assertions which ought not stand unchallenged on the record of these hearings. Moreover, in our opinion, neither statement reflects an adequate understanding of the serious and complex problems arising from products liability.

This letter, which it being sent to all members of the Subcommittee, represents an examination and critique of the testimony of both the American Insurance Association and the Treasury Department. We ask that it be considered as a supplement to our principal statement and included in the official printed record.

Our statement considers first the testimony of the American Insurance Association and then that of the Treasury.

TESTIMONY OF THE AMERICAN INSURANCE ASSOCIATION

Commercial Insurance Versus Self-Insurance

This aspect of AIA testimony is summarized as follows: "The current treatment of self-insurance and commercial insurance under the Code is balanced * * *. The deficiencies of self-insurance have nothing to do with taxation." The second of these conclusions does not follow from that which has gone before and serves only as an introduction to a following statement which is either incorrect or misleading, or both. We have in mind this statement, "Self-insurance for most manufacturers is nothing more than a voluntary bookkeeping segregation of assets. The self-insurer continues to control its funds, and may liquidate them at will * * *." One must assume that these statements were written by someone who had not examined the content of S. 1611 and S. 3049. Each of these bills defines "product liability loss reserve account" as meaning a trust created and organized in the United States and both appear to require the payment over to the trustee of cash to fund the reserve in question.

Although MAPI's principal statement takes account of the possibility and cautions against it, it does not seem to us that any responsible reading of these two bills can be construed as tolerating "* * * nothing more than a voluntary bookkeeping segregation of assets." As for the liquidation "at will" of any such trust, S. 3049 specifically provides that "the time, manner, and conditions under which a taxpayer may terminate his product liability loss reserve account" are to be determined under regulations prescribed by the Secretary of the Treasury. The point is not specifically dealt with in S. 1611 but this seems to us a very simple problem to solve and one which is, in any event, unrelated to the assertions of AIA as quoted above.

Market Problems Are Over

Here we are told that, "Our members question whether a serious product liability insurance problem exists today." It goes on to say that, "Unexpected cost increases produced temporary dislocations in the insurance market. Those dislocations are behind us." With the permission of the chair, MAPI introduced into the record of these hearings a copy of an Institute survey completed in August 1976 and which examined fully under the headings of "Products Liability Insurance Coverage" and "The Cost of Products Liability" the availability and affordability of this coverage. As the summary of that survey points out:

More than 94 percent of those companies which answered the question indicated that their products liability premium rates had increased over the past five years, in addition, more than one-third of these companies were required to accept a deductible or a large retrospective retention. In percentage terms, the premium rate increases ranged from 0 to more than 4,000 percent with some 58 percent of the companies responding to this question reporting increases between 100 percent and 1,000 percent.

Obviously, this survey was completed more than two years ago and the situation should be examined currently. If one accepted AIA testimony, one might believe that "Those dislocations are behind us." We do not believe that assertion because since conducting the original survey we have on three occasions rechecked its findings as to the availability and affordability of products liability insurance. The most recent such check was made in July of this year with the mem-

bers of the MAPI Products Liability Council which is comprised of representatives from 62 companies who are thoroughly versed in the present realities of products liability insurance availability and related problems. The results of this check were summarized in our principal statement but for purposes of continuity, we repeat a part of that testimony here:

81 percent of the companies responding indicated that their products liability "problem" has increased during the last two years. Another 17 percent indicated that the problem has remained constant and unabated during the same period of time. Only 2 percent indicated that their products liability problem has diminished.

Does this sound as if "Those dislocations are behind us"? As for the range of increases in products liability insurance premiums, our recent recheck survey came to these conclusions:

* * * Among those indicating increases the responses vary dramatically from less than one percent to 1,300 percent in the last two years, and from less than one percent to 215 percent within the last year. Of the companies reporting higher insurance costs, 16 (34 percent) indicated increases of 100 percent or higher during the last two years; and 5 companies showed increases within the last year of 50 percent or greater.

As this Subcommittee will recall, testimony to similar effect was introduced in the recent Subcommittee hearing by substantially all of the industry witnesses who appeared.

Incidentally, it was noted in the course of oral testimony before the Subcommittee that the unavailability and the unaffordability of products liability insurance should be considered as synonymous. We agree completely and point out that the observation is directly pertinent to this aspect of AIA testimony concerning its Market Assistance Programs (MAPs). We do not doubt the assertion that "several state MAPs are experiencing lower activity in recent months." Is this because "dislocations are behind us" or is it because coverage is available only at a price which the potential applicant cannot possibly afford? Our experience with member companies suggests that lower MAP activity may be the result of MAPs offering coverage that is inadequate or inappropriate.

Not viable for small business

This passage in the AIA testimony opens with this paragraph:

Product liability insurance costs are estimated to be less than 0.5 to 1.0 percent of sales. Generally it is the small manufacturer of a single product which is forced to pay more than 2.0 percent of sales.

One wonders if these figures do not prove more than was intended. If products liability insurance costs range from 0.5 percent to 1.0 percent of sales (we are not told the source of this estimate), they represent a substantial slice of profits. The Federal Trade Commission's Quarterly Financial Report for manufacturing, mining and trade corporations for the first quarter of 1978 reveals that net income as a percentage of sales for All Manufacturing for the first quarter of this year was 4.7 percent. Thus, products liability insurance costs would range from 10.6 percent to 21 percent of net profits. These percentages would be higher in the case of Fabricated Metal Products where net profit as a percentage of sales is 4.0 percent, and lower in the case of Machinery, Except Electrical and Electrical and Electronic Equipment for which the corresponding net profit figures in the first quarter of 1978 are 6.7 percent and 5.2 percent, respectively.

For the small manufacturer of a single product which is forced to pay [for products liability insurance] more than 2.0 percent of sales according to the AIA estimate, the percentage of net profit represented by such expense for All Manufacturing and for the three manufacturing categories cited above would be: 42.5 percent, 50 percent, 30 percent, and 38 percent.

When net profit, the objective and hoped-for end result of business activity, is potentially affected by products liability insurance premiums to the extent indicated by these figures, how is it possible to say "These dislocations are behind us."

The central message of this passage in the AIA statement is this: "Encouraging small business to self-insure through tax incentives is an unworkable concept." In support of this assertion, it is said: "It will not reduce the aggregate demand for insurance coverage by small business. It will not produce lower prices for insurance purchased by small business. It could mislead and fail to compensate injured consumers." Let us examine each of these three propositions.

It is very possible that "[i]t will not reduce the aggregate demand for insurance coverage by small business." Who has said that it would? What manufacturers—large and small—are concerned with is the supply of affordable coverage not the demand for it. The real purpose of the proposals before this Subcommittee is to increase underwriting capacity which, according to the oral testimony on August 28 of the witness representing the National Insurance Brokers Association, is now, and for some time has been, insufficient. If underwriting capacity for this coverage is insufficient—and all evidence from objective witnesses holds that it is—then an increase in such capacity effectuated by tax deductible contributions to self-insurance reserves would be likely to increases, not decrease, aggregate demand.

Since we have no control over the premium rating of products liability insurance risks we cannot assert with any real confidence that adoption of this legislation will produce lower prices for insurance purchased by small business. However, we suspect that it may. If underwriting capacity were increased by this legislation and if the casualty insurance industry is as competitive as AIA testimony holds it to be, then, sooner or later, we think AIA's concern is largely directed at the increase in underwriting capacity which this legislation would produce and the possible resultant loss of business to established insurance carriers.

Finally, we are told that self-insurance contemplated by these proposals " * * * could mislead and fail to compensate injured consumers." It may well be that, in some cases, there will be a failure to compensate injured consumers. That possibility exists now and largely because of the failure of the insurance industry to provide sufficient underwriting capacity and not because of shortcomings which it foresees in a potential competitor.

"Defense and claim handling costs will be high for small business," we are told by AIA's statement. Of course they will. And this is exactly why small business needs the benefits which adoption of this legislation would give it—to spread the very substantial costs of products liability related costs over a period of years.

And then we are told "Small businesses will probably not be able to institute and supervise quality control programs on their own." Does this imply—as it seems to—that only insurance company representatives are competent to guide quality control programs of small manufacturers. We do not represent and do not speak for small business in a broad sense[1] but we cannot fail to observe that this statement strikes us as being almost breathtakingly arrogant. Is the insurance industry saying that—in most cases—it knows better how to manufacture a safe product than the company—or the man—who created the product and devised the process for its manufacture? That seems to be exactly what it is saying and, if so, it seems to us a generalization that is simply untrue. (We acknowledge, of course, that some insurance carriers have been helpful in the development of individual company programs—including quality control—to reduce the products liability hazard.)

Next, the AIA statement declares that, "Instead of complete self-insurance, some suggest small business could use a tax-free reserve to support a deductible to lower premiums." The statement goes on to say that the insurance industry has encouraged the use of deductibles by industries which experience many claims, and that where claims frequency rather than severity is the problem, higher deductibles help reduce premiums.

e. Large trust funds have fiduciary responsibilities which must be defined. Standards and guidelines for self-dealing and prohibited transactions must be included. Mechanisms for effective monitoring should be established.

We have already commented sufficiently on safeguards already written into the proposed legislation. If additional safeguards are required, by all means include them, but let us not be deluded by rhetoric.

Revenue loss.—Reference is made by AIA to the loss of revenue that would result from enactment of authority for tax deductions for self-insurance reserves. We will not argue with the figures as stated but, as in the case of earlier Treasury estimates, they appear to omit altogether any reference to revenue loss that will occur in any event as a result of the payment of products liability claims and related expenses.

At least three situations involving tax deductibility are possible here: A company buys products liability insurance and immediately deducts the cost of pre-

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[1] It is true however, that there are a significant number of small businesses in the MAPI membership and we have considerable familiarity with their problems.

miums paid. Second, a company cannot purchase such insurance at reasonable cost and, under authority of the proposed legislation, elects to establish a self-insurance trust and currently deducts contributions to that trust. Third, having neither commercial insurance nor self-insurance available to it, a company "goes bare" and ultimately sustains a products liability loss together with such related expenses as legal fees. tI pays the total of such expenses and thereupon deducts that amount as a business expense and/or a casualty loss. It is very possible that revenue losses resulting from such ultimate payment of products liability losses will equal or even exceed the revenue loss estimated for the self-insurance approach. The principal difference is in the matter of timing.

Tort Reform

We are told by AIA that the only effective way to modify the causes of unreasonable products liability claims is to convince state legislators to reform tort laws and to modify decisions of tort cases by state courts. The statement of AIA goes on to say that "Federal tax bills only treat symptoms of the product liability problem. Tort reform is a long, tedious procedure, but it is the only way to reach the causes of the problem."

Are we to understand from the manner in which this "unanswered public policy question" is stated that the American Insurance Association is somehow opposed to the manufacture of power tools, power lawnmowers, microwave ovens, etc.? Does it oppose only the "subsidizing" of the manufacture of dangerous or potentially dangerous consumer products?

And why is it that enactment of authority for self-insurance would constitute any greater subsidy for those who might benefit from such authority than does the present right to deduct the cost of premiums paid for products liability insurance?

Unwittingly, we think, by raising this question AIA has put its finger on a much greater public policy issue raised by this whole problem area and which has thus far received only scant attention: What is the effect of the products liability threat on research and development and technological progress generally. This "unanswered policy question" is, in our judgment, more important than all of the questions raised here.

c. The legislation would violate long-established principles handed down by the U.S. Supreme Court that tax deductions are available only for a fixed or known liability, not for a contingency. New opportunities for tax evasion would be opened if these historic principles were ignored.

We are not familiar with the case or cases to which this declaration obviously adverts. If, however, the principle of law is as stated then it would seem also to bar deductions paid for products liability insurance since it is obtained for the purpose of making provision against contingencies and not to cover fixed or known liabilities. And how would "new opportunities for tax evasion * * * be opened if these historic principles were ignored"? The fact is that both S. 1611 and S. 3049 call for creation of trusts to be administered by independent trustees and thus subject to the very strict provisions of trust law. Moreover, as noted previously, the applicable provisions of the Internal Revenue Code would provide for the filing annually of a tax return for the trust. Finally, the bills now before the Congress, particularly S. 3049, have been carefully written to prevent any possibility of abuse. We think the suggestion of the AIA in this regard is a very red herring.

d. Congress has granted special tax procedures for insurance reserves because they are subject to specific regulatory and accounting safeguards.

This declaration is unquestionably true and we agree with it. However, we do not agree with its rather clear implications that safeguards against abuse would be insufficient under proposals now before the Subcommittee.

However, it is noted, "[i]n product liability * * * severity and irregularity would cause a higher deductible to be meaningless for a small business."

Why would it be "meaningless" if the small manufacturer cannot obtain products liability insurance coverage or, if he can, only at an annual cost approximating the level of coverage? (This latter example is supported, incidentally, both by testimony on August 28 and the Institute's experience.)

And would "[t]he reserves permitted under all of the pending bills * * * be insignificant in relation to a single product liability claim?" This seems to us an understatement as to the amount of reserves possible under S. 1611 and an overstatement in holding that any products liability claim would exceed the reserve accumulation. This, however, is really in the nature of an aside—the real issue

is the usefulness of the principle embodied in these two proposals to cover the gap between the "first dollar" and the level at which commercial insurance coverage cuts in. Regardless of the findings of Gordon Associates, our continuing contact on this subject with some 500 capital goods manufacturers persuades us that many of them have been induced—by exorbitant premiums or by a flat refusal by an insurance carrier to provide first dollar coverage—to accept substantial deductibles or "retentions." Self-insurance could help to cover this gap and because of lesser capital availability such coverage would be especially important to smaller companies.

Unanswered public policy questions

The summary of AIA's statement as presented to the Subcommittee identifies a series of "unanswered public policy questions" that would be raised by adoption of S. 1611 and S. 3049. Moreover, it is suggested that adoption of the principles embodied in these proposals would "open new opportunities for abuse." Each of these questions is considered below:

a. What would be the impact upon creditors' rights under state laws in the event of insolvency or bankruptcy?

We have no particular comment here except to say that the law of creditor rights is so well developed that we see no difficulty in applying it to insolvency or bankruptcy involving a trust created under legislation of this character. Perhaps it should be added that "insolvency and bankruptcy" are very likely to be more widespread; particularly among smaller manufacturers, if some form of interim relief is not provided.

b. Should Congress use the Code to subsidize the manufacture of complex and potentially dangerous consumer products—power tools, power lawnmowers, microwave ovens, etc.

We are bound to say that this statement does not reflect great credit on the insurance industry. In plain language that industry is saying to manufacturers and sellers of goods, "We think you should be denied any temporary relief from a problem which we, the insurance companies, played a considerable part in creating." If that assessment seems too harsh, we suggest the Subcommittee consider the Final Report of the Task Force on Product Liability which concludes, inter alia, that "liability insurance rate making procedure is one of the three principal causes of the products liability problem." Moreover, the Commerce Department acknowledged in the Options Paper of the Interagency Task Force that the situation calls for short-term relief.

Even the Treasury Department, the views of which prevailed in Administration councils—and with which we thoroughly disagree on this issue—sees the need for temporary relief although we do not think its proposed solution is a very useful one. Of all interested parties, only the insurance industry, as represented by AIA, is prepared to say that "[t]he only effective way to modify the causes of unreasonable product liability claims is to convince state legislatures to reform tort statutes, and to modify tort decisions by state courts." We think this counsel insensitive and irresponsible and it should be disregarded by the Congress. This does not mean, of course, that we oppose tort reform.

Testimony of the Treasury Department

The substance of the Treasury Department's case against tax deductibility for contributions to self-insurance reserves is stated on page 5 of its formal statement before this Subcommittee on August 28 in this language:

* * * The reasons that led the Administration not to endorse a deduction for contributions to product liability self-insurance reserves are essentially three. First, the superficially appealing notion that the tax discriminates in favor of commercial insurance and against self-insurance is in fact based on a misapprehension. Second, the existing proposals for current deductibility of contributions to self-insurance trusts provide an opportunity for deferral of taxes and thereby would operate to subsidize self-insurance. Because self-insurance is inherently inefficient by contrast with commercial insurance, and because of technical difficulties stemming from the inability to estimate future product liability losses, we concluded that extending such a subsidy would not be appropriate. Finally, we concluded that existing law, with some modification, would provide virtually the same tax benefits, other than deferral, as proposals providing current deductibility for contributions to a self-insurance trust, and with far less administrative complexity. The necessary modification, as I have already noted, would be to amend current law to provide a special 10-year net operating loss carryback, in

contrast to the three-year net operating loss carryback generally available under current law, for losses attributable to product liability * * *.

We are not greatly impressed by the somewhat labored argument which seeks to prove that there is no discrimination between the manufacturer who can obtain products liability insurance at an affordable price and deducts the cost of premiums paid versus the manufacturer who cannot obtain such insurance at reasonable costs and can take a tax deduction for products liability losses only after they have actually been paid. At least two things are wrong with the argument as stated. Referring briefly to the quotation from the Treasury Department statement cited above, we are told in and elaboration of this introductory statement that "[t]o the extent the loss is reimbursed by the insurer * * * no further deduction is permitted even though because of earnings on the reserve the total amount of losses might well exceed the premiums paid. If this were the case, the total deduction to the self-insurer is greater and offsets the benefit obtained from the earlier deduction by those who use commercial insurance." Let's suppose that this is not the case. How then is the benefit obtained from the yearly deduction offset?

Secondly, we are told that "* * * one must recognize that conferring current deductions for contributions to self-insurance trusts, where such trusts are tax exempt, invariably gives rise to tax deferral. That deferral constitutes a subsidy to self-insurance * * *." [Footnote omitted.] We fail to understand why the deferral of tax on funds placed in the self-insurance reserves constitutes any greater subsidy than an amount paid to a commercial insurance company for products liability insurance coverage. This is all the more true, as the MAPI statement to the Subcommittee suggests, where the measure of tax deductibility is limited to an actuarially determined estimate of the proper amount to be reserved on an annual basis and with the total accumulation subject to an overall maximum limitation. To pursue this argument one step further, the Treasury argument holds that "* * * the greatest benefits would accrue to those whose funds remained on deposit the longest, who well might be those with less in the way of product liability losses." If this is the touchstone for determination of subsidies then it would appear to apply equally, as we have noted, to premiums paid for commercial insurance as to sums contributed to self-insurance reserves. Nevertheless, we find it very strange to characterize as a "subsidy" a benefit resulting from the combined effects of the production of a safe product, good management, and good luck.

It seems to us, as a matter of fact, that Treasury's pursuit of this issue raises another basic policy question—why shouldn't the government "subsidize" or encourage prudent and consumer-oriented behavior by industry? Clearly, the tax system has always sought to provide such encouragement where the public interest would be benefited.

Treasury also complains that tax deferral benefits would "vary with the marginal rate of the taxpayer." To be sure, benefits will vary somewhat with the variance in applicable marginal corporate tax rates but does not this same "discrimination" apply across the board. Why pick on this particular type of deduction?

The efficiency of self-insurance

We are even less impressed with the simplest discussion of self-insurance as "the least efficient form of insurance," appearing on page 7 of the Treasury testimony.

To begin with, what of the "acquisition cost," the agent's commission, which is not even a part of the cost of self-insurance? Is not cost a part of efficiency? More importantly, it seems to us that "greater efficiency" is a matter for the insured, not the Treasury to decide.

This argument of the Treasury necessarily assumes that contributions to a self-insurance reserve, as contemplated by the legislative proposals before this Subcommittee, would cover the whole of any manufacturing company's products liability risk. That is not the case. In the vast majority of cases such self-insurance would be elected for the purpose of covering the gap between the first dollar of loss and that point at which by choice or by imposition of a deductible by the insurance company commercial insurance "cuts in."

The measure of tax deductibility

Treasury testimony points to the difficulty under the varying measures of deductibility spelled out in S. 1611 and S. 3049 of establishing any relationship between allowable deductions and the magnitude of products liability risks.

There is something to this point but not much. The problem is not an insuperable one. As noted above, the Institute has suggested that tax deductibility might be conditioned upon "independent actuarial certification—submitted to the IRS perhaps every three years—as to the proper amount for the individual taxpayer." Commercial insurance companies also base premiums on actuarial calculations and thus the MAPI suggestion should result in estimates as accurate as those stemming from the insurance trade. In this connection, we call the Subcommittee's attention to the report of the House Small Business Subcommittee on Capital, Investment and Business Opportunities (Report No. 95-997, March 21, 1978) which concluded at page 71 that, "It is statistically impossible to verify the accuracy of any product liability premium."

The issue of complexity

We are told at page 9:

* * * the existence of exempt, self-insurance trusts would require complex administrative controls. For one thing, the Internal Revenue Service would be required to insure that such trusts were not overfunded and that their investments were limited in the manner required by, for example, S. 3049. Moreover, extremely complex accounting would be required to define the appropriate tax treatment to be applied on nonqualifying distributions from, or liquidations of, such product liability loss reserve accounts. Presumably, the sponsors of such provisions would wish to provide that, if an enterprise established a product liability loss reserve account and, after a number of years, decided that it no longer needed the account, the taxpayer should reap no benefits by virtue of having established and maintained the account. In order to give effect to this result, extremely complex accounting provisions would be required to bring the taxpayer back to square one. It would, I should note, not be sufficient simply to provide that all amounts distributed from the account be subjected to tax.

We think the Treasury "doth protest too much." Most of the complexities foreseen by Treasury testimony have already been anticipated and dealt with by draftsmen of the several legislative proposals of this character now before the Senate and the House. Additional difficulties identified in the Treasury statement do not seem to us all that severe. The fact is that both S. 1611 and S. 3049 call for the establishment of trusts, presumably with a bank serving as trustee in most cases, and, under Code provisions applicable to trusts, each such reserve would have filed for it annually its own tax return. Thus, automatically and without the need for special digging, the IRS would have available to it a full report on the status of any such trust including payments to, and disbursements from, the corpus of the trust in the course of the last taxable year. To the extent that IRS might for some reason desire to inquire further the tax return of the trust provides a starting point for any such audit.

The administration proposal

Finally, let us take a look at the Administration's which is to say, the Treasury Department's—counter-proposal. In brief, it calls for an extension of the current three-year net operating loss carryback to ten years for products liability net operating losses, where those losses cannot be absorbed under the current three-year program. The Treasury spokesman has said "as modified by this proposal, we believe that current law will provide nearly all the benefits to taxpayers—other than deferral of taxes—that they would obtain from being permitted to deduct contributions to a product liability self-insurance trust."

Will this proposal "* * * provide nearly all the benefits * * *" of tax deductibility? Almost certainly not, in our opinion.

As provided in the Administration's proposal, a company suffering products liability losses could file amended returns for the preceding 10 years only where a three-year carryback results in excess products liability-related net operating losses. However, such a company could recoup such losses only if it has been profitable and has paid taxes in the years to which amended returns apply. Suppose the company is a new one? Suppose it reported low, or no, profits in the prior 10-year period? Are we to understand that a company with a $1 million profit from operations and a $1,005,000 products liability loss can take only $5,000 as a net operating loss carryback? Such a system requires uninsured small companies, in effect, to absorb totally the financial consequences of a catastrophe, thereby discriminating against them in favor of large corporations, which can more readily obtain excess coverage. Furthermore, where a small company's ability to obtain excess insurance coverage is contingent upon proof of adequate financial responsibility in the primary (first-dollar) layer, the Administration's proposal offers little if any assistance.

Let us consider some practical situations and see for ourselves if the Treasury proposal would provide "virtually the same tax benefits." First, let us assume a smaller business with annual taxable profits of $50,000 (i.e., during each of the 10 preceding years after-tax profits of $50,000 were realized); a $500,000 uninsured loss (an increasingly common occurrence) could be accommodated under the Administration's proposal, but only to the extent of a $105,000 refund of previously paid taxes (based upon the current federal tax rate of 21 percent for a company with such profits). This would still leave $395,000 cash that the business would have to provide to cover the remainder of the loss. The mere fact that this sum may be theoretically deductible under the present Code would be of no help in obtaining this amount where the company was in a net operating loss position—which is a precondition to invocation of the carryback.

Second, assume an even smaller business with a $10,000 taxable income in each of the preceding 10 years. If that business had a $100,000 uninsured loss, the loss carryback approach would provide only a $20,000 tax refund (based upon a current tax rate of 20 percent) and would require the company to provide $80,000 cash to cover the loss—cash which very probably is not available. Under the tax set-aside approach of both S. 1611 and S. 3049, a prudent corporation would be encouraged to prepare in advance for scuh potential losses by setting aside currently deductible contributions to a reserve or trust and could, therefore, hopefully avoid the obliteration of 10 years' income and an operating loss during the current year for which no deduction is effectively available, and which might even jeopardize the very life of the uninsured corporation.

Moreover, the Administration's proposal would be equally useless at the other end of the industrial scale. In the case of larger companies, products liability losses will rarely equal profits for the year. Thus, there would be no net operating loss, no carryback, and no offsetting refund. But there would be substantial revenue loss—the Treasury's principal concern, we think—as products liability claims and expenses paid directly by the corporation through self-insurance are taken as tax deductions.

To sum up, the Administration proposal would assist far fewer companies than would the tax-deductible loss reserve approach of both S. 1611 and S. 3049 and would, accordingly, represent a far less effective response to the increasingly serious problem of products liability. We think it should be rejected.

Summary of Statement by Walter D. Vinyard, Jr. American Insurance Association

1. The American Insurance Association, whose members underwrite 85 percent of product liability insurance sold in the United States, is strongly opposed to amending the Internal Revenue Code in order to provide tax deductions and tax-exempt trust funds for self-insurance against product liability or other casualty/liability risks.

2. The current tax treatment of self-insurance and commercial insurance under the Code is balanced. Deficiencies in self-insurance have nothing to do with taxation.

3. Self-insurance for many manufacturers is nothing more than a voluntary bookkeeping segregation of assets, entirely under the self-insurer's control. No risk is transferred. No regulatory supervision exists to guarantee injured consumers will be compensated.

4. Temporary dislocations in the market for product liability insurance are over. Market assistance programs in 26 states have helped hazardous industries locate coverage. Applications for help are declining.

5. Encouraging small business to self-insure through tax deductions and trusts is an unworkable concept. Large corporations with product diversity and sizeable cash flow can self-insure, and are doing so without tax deductions. Small business cannot self-insure with or without tax deductions.

6. Deductibles are not useful where claims severity rather than frequency is the problem. The unpredictability and size of product claims cause deductibles to be meaningless for small business. Product liability losses consist of a few large claims at irregular intervals over a long period.

7. S. 1611, S. 3049, as well as other bills introduced in Congress, raise unanswered public policy questions, and open new opportunities for abuse:

a. what would be the impact upon creditors' rights under state laws in the event of insolvency or bankruptcy?

b. should Congress use the Code to subsidize the manufacture of complex and potentially dangerous consumer products.

c. the legislation would violate long-established principles handled down by the U.S. Supreme Court that tax deductions are available only for a fixed or known liability, not for a contingency. New opportunities for tax evasion would be opened if these historic principles were ignored.

d. Congress has granted special tax procedures for insurance reserves because they are subject to specific regulatory and accounting safeguards.

e. large trust funds have fiduciary responsibilities which must be defined. Standards and guidelines for selfdealing and prohibited transactions must be included. Mechanisms for effective monitoring should be established.

8. The loss to the Treasury which would result from enactment of product liability self-insurance legislation could range from $36 million to $12 billion depending upon the specific alternative. S. 3049 would increase revenue lost to the U.S. Treasury from $106 to $296 million. These figures are from an August 15 report to us by the independent firm of Brimmer and Company.

9. The only effective way to modify the causes of unreasonable product liability claims is to convince state legislatures to reform tort statutes, and to modify tort decisions by state courts. We invite all concerned parties to join us in this effort. Federal tax bills only treat symptoms of the product liability problem. Tort reform is a long, tedious procedure, but it is the only way to reach the causes of the problem.

Statement by Walter D. Vinyard, Jr., Senior Counsel, American Insurance Association

My name is Walter D. Vinyard, Jr., and I am Senior Counsel for the American Insurance Association, an organization of property-casualty insurers which underwrite approximately 85 percent of the product liability insurance sold in the United States. We appreciate your courtesy in allowing us to appear today in order to express our strong opposition to the concept of amending the Internal Revenue Code in order to provide tax deductions and tax-exempt trust funds for self-insurance against product liability, as well as other casualty/liability risks.

The current treatment of self-insurance and commercial insurance under the Code is balanced. Insurance premiums are deductible when paid. Losses paid by an insurance company are not deductible. Property-casualty insurers are taxed currently on income. No structural changes are needed in the Code. The deficiencies of self-insurance have nothing to do with taxation.

Self-insurance for most manufacturers is nothing more than a voluntary bookkeeping segregation of assets. The self-insurer continues to control its funds, and may liquidate them at will. When a manufacturer purchases insurance from a company fully regulated by a state insurance department, the manufacturer transfers risk of loss to an independent concern regulated for solvency. Even if the regulation fails, the state commissioner and other companies doing business in that jurisdiction guarantee payment of claims by injured consumers.

Market Problems Are Over

Our members question whether a serious product liability insurance problem exists today. Significant changes in the law of strict liability by state courts did result in dramatic increases in insurance claims costs. The average incurred bodily injury claim cost rose from $6,000 in 1972 to $19,500 in 1974, according to the Insurance Services Office. Hazardous industries—industrial machinery, chemicals, automotive components, medical devices and pharmaceuticals—found insurance premiums increased from 100 to 500 percent. As a result of the way state courts apply tort law, there was no single event to which any one could point as causing cost increases. Unexpected cost increases produced temporary dislocations in the insurance market.

The dislocations are behind us. Twenty-six states have created market assistance programs (MAPs) to help impacted industries locate insurance coverage. Approximately 800 companies have submitted MAP applications nationwide. In many cases, MAPs find an underwriter by exploring every available market. Often brokers or agents cannot do this alone. Several state MAPs are experienc-

ing lower activity in recent months. A number of other state MAPS have never received more than a few applications. I would like to introduce for the record a report by our Association on the status of state market assistance plans [Attachment A].

NOT VIABLE FOR SMALL BUSINESS

Product liability insurance costs are estimated to be less than 0.5 to 1.0 percent of sales. Generally it is the small manufacturer of a single product which is forced to pay more than 2.0 percent of sales.

Advocates of tax incentives for self-insurance explain they want to help large small businesses, e.g., those with gross sales of $1,000,000 to $5,000,000. Encouraging small business to self-insure through tax incentives is an unworkable concept. It will not reduce the aggregate demand for insurance coverage by small business. It will not produce lower prices for insurance purchased by small business. It could mislead and fail to compensate injured consumers.

Product liability self-insurance must have two objectives. The self-insuring business must be able to spread its exposure to product liability loses evenly over a period of years. It must also be able to compensate injured persons quickly. To do this, a self-insurer must accumulate and maintain a substantial pool of assets. Large corporations with product diversity and sizeable cash flow are doing this without tax incentives. Small businesses cannot. A "Survey Report on Product Liability" published by the National Federation of Independent Business in January 1977 discovered that 42.8 percent of small businesses responding could not establish a self-insurance trust fund. Another 24.8 percent reported they could do so, but with difficulty. Only 5.9 percent indicated a trust fund was readily possible. Eight percent already possessed a self-insurance fund.

Defense and claim handling costs will be high for small business. For every dollar of indemnity paid through the product liability system, insurers spend $0.34 for defense against bodily injury claims, and $0.48 on property damage claims. Most of these expenses are for legal counsel. Legal costs will be higher for small business because they do not employ in-house lawyers. Small businesses will probably not be able to institute and supervise quality control programs on their own. Approximately 5.8 percent of net billed sales is required today to maintain a quality control program.

Instead of complete self-insurance, some suggest small business could use a tax free reserve to support a deductible to lower premuims. Our industry has encouraged use of deductibles by industries which experience many claims. Where claims frequency rather than severity is the problem, higher deductibles help reduce premiums. In product liability, however, severity and irregularity would cause a higher deductible to be meaningless for a small business. The reserves permitted under all of the pending bills would be insignificant in relation to a single product liability claim. They would be inconsequential in pricing policies to cover the excess.

Gordon Associates' survey for the Interagency Task Force Report found the average deductible level has decreased for small firms. It has increased for large and medium sized firms. Gordon noted an increase of over 400 percent in the average number of pending claims per firm since 1971. The number of new claims seemed to have peaked in 1974. The average amount sought in new claims has increased to over $1,500,000. For pending claims average damages have risen over $3,000,000.[1]

Product liability losses usually consist of a few large claims at irregular intervals over a given time period. In the final analysis, after taking into account all of an insurer's actuarial skills and experience, product liability rates and reserving involve an insurer's best judgment. The nature and frequency of claims is too erratic to permit use of actuarial tables in the same way as a life company computes policy costs. An atomistic market structure, a relatively moderate level of concentration, and vigorous competition among hundreds of companies work efficiently to reduce insurance rates, particularly in commercial policies. No single insurance group accounts for a major share of the market. There are no price leaders. These facts were affirmed by a major investigation and report on "The Pricing and Marketing of Insurance" by the Justice Department's Antitrust Division in January 1977.

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[1] Interagency Task Force on Product Liability, Product Liability: Final Report of the Industry Study—Volume I and II, National Technical Information Service, U.S. Department of Commerce (April 1977).

Over the past eighteen months, several manufacturing associations have surveyed their members' products liability experience. There may be a bias in the responses because only companies with problems would bother to reply. Those satisfied with current insurance coverage might not complete and return a survey. Our staff summary of those surveys is enclosed, including other surveys conducted by insurance organizations [Attachment B]. Addresses are given from which complete copies of each survey may be obtained.

CASE STUDIES OF FOUR INSURED SMALL BUSINESSES

In an attempt to help demonstrate problems with self-insurance or deductibles for small business, our staff has produced a study of four insured small businesses [Attachment C]. Self-insurance is defined as total responsibility for investigation, settlement and payment of claims.

Four small businesses were selected from several companies seeking insurance through one of the state MAPs. The selected firms included manufacturers of mechanical power presses, nonpowered hand tools, ski equipment and electronic components. Their sales, limits of liability, premium rate and premium paid are noted. The average claim cost, the total loss expectation and the "normal" annual costs were derived from actual MAP applications. No modifications were introduced into actual data. We have attempted to compare the cost of insurance at the applicant's own desired limits of liability with self-insurance or deductible coverage up to the same limits. One premise is that all claims would be incurred at the average claim cost for the type of business involved, as reflected in the ISO Product Liability Closed Claim Survey. Patterns of comparison for the various models would be significantly different if this average were varied. The impact would also differ depending upon the nature of the claims. Regardless of what average is used, the extreme volatility or range of the size of a claim would present a problem for an individual small business. Totals are used to show how far a fund for self-insurance, or use of the fund for deductibles will go. For ease in comparison, it is presumed the business would pay into the fund the equivalent of insurance premiums he would have otherwise paid subject to 3 percent of maximum sales.

It would take only one or two claims before the funds would reach their limit. Some firms are quoted as asserting that they have never experienced a claim, or have had very few in the last ten or twenty years. This is not surprising given the low frequency, high severity characteristics of products liability. For some firms, the administrative costs needed to self-insure may be quite high (two percent of sales for mechanical power presses). These additional costs are not paid out of the fund, although they are deductible. In three of the four examples where the firm chose to establish a fund to be used as a deductible, the fund was depleted with only one claim (in the other case it was 90 percent depleted after one claim).

For bodily injury only, the limits of liability chosen by insureds suggest they expect between seven and nine claims per year. If those claims materialize, their fund would fall at least $150,000 short. For the concept of insurance to work at the individual risk level, the reserve must be relatively loss free for several years in order to accumulate adequate funds to absorb losses. There would be a natural reluctance for a firm to commit money to a self-insurance fund against which few if any losses were charged. The range in average premium per dollar of sales, the dollar average claim cost, and expected number of claims is a higher variable among the four businesses studied. A summary of key values follows:

Model No.	Insurance premium, sales (percent)	Average claim cost	Annual expected number of claims	Number of claims required to exceed insurance premium: Full program	Deductible program
1	8.1	69,718	1.14	2	2
2	.5	32,579	.61	1	1
3	1.1	54,307	.16	1	1
4	.3	523	.59	1	1

Even with widely varying exposure to loss frequency and average claim size, the cost of self-insurance or a $25,000 deductible program would exceed the equivalent insurance premium with one or two claims.

It is important to stress these comparisons are based on average results. No losses would occur for the majority of businesses in the first year. For the relatively smaller number which experience more claims, serious financial consequences would occur.

POTENTIAL FOR ABUSE

S. 1611 and S. 3049, as well as other bills introduced in Congress providing self-insurance deductions and trust funds, raise a host of fundamental public policy questions. Our special counsel, Shea Gould Climenko and Casey, has studied these questions. A copy of their opinion is included for the record [Attachment D]. There is no assurance funds will be available to assist injured persons at the time of their loss. The bills pending before the Finance Committee raise unanswerable questions regarding creditors' rights generally under various state laws in the event of insolvency or bankruptcy. The complexity of problems in this area requires far more consideration than has yet been given.

There is also a serious question whether the Code should be used to subsidize the manufacture of complex and potentially dangerous consumer products—power tools, power lawnmowers, microwave ovens, etc. An indirect tax subsidy would make it difficult for buyer and seller to understand the full costs and benefits to them of manufacturing, selling and purchasing those products.

The legislation ignores long-established principles handed down by the U.S. Supreme Court that tax deductions are available only for a fixed or known liability, not for a contingency. Many taxpayers would like to reduce taxes by establishing a contingency reserve, particularly if no regulatory or accounting procedures were established to insure the security of reserves.

Adoption of a reserve mechanism free from any regulatory supervision is unwise. Analysis of other Code sections relating to deductions for certain reserves such as those maintained by commercial banks or bad debts reveals that they are different in substance and effect from the pending bills. Congress has recognized the importance of regulation of such reserves by granting tax deductions only for reserves which meet certain regulatory and accounting standards established for insurance and banking.

Development of large trust funds inherently involves fiduciary responsibilities. Any legislation creating such trusts must include standards and guidelines regarding self-dealing or prohibited transactions. Mechanisms for effective monitoring of fund performance should also be established. Beneficiaries of the trust who are to be protected must be identified.

REVENUE LOSS

The loss to the U.S. Treasury which would result from enactment of S. 3049, which provides deductions for five percent of gross receipts, would be $12.3 billion, according to an August 15 report by the independent consulting firm of Brimmer & Company [Attachment E]. This could increase to $23.2 billion under another set of factual assumptions. Under clause B of S. 3949, which allows deductions for two percent of gross receipts, the loss to the Treasury would be from $9.4 billion to $6.6 billion. Under any of the other self-insurance bills introduced so far in Congress, the loss in revenue to the Treasury would also be substantial.

I hope this information will be helpful to the Committee and its staff in evaluating various self-insurance proposals. Please let me know whether any other material would be useful.

Respectfully submitted,

WALTER D. VINYARD, Jr.
Senior Counsel.

ATTACHMENT A

REPORT ON

STATUS OF STATE ACTIVIATION

OF INSURANCE INDUSTRY'S VOLUNTARY RESPONSE

TO ALLEGED PRODUCT LIABILITY

INSURANCE AVAILABILITY SHORTAGE

Joseph Miller, Economist

American Insurance Association

States with Operational M.A.P.

- Arizona
- Arkansas
- California
- Connecticut
- Illinois
- Indiana
- Kansas
- Louisiana
- Maine
- Massachusetts
- Michigan
- Minnesota
- Missouri
- Nebraska
- New Hampshire
- New Jersey
- Ohio
- Pennsylvania
- Rhode Island
- South Carolina
- South Dakota
- Tennessee
- Texas
- Virginia
- Washington
- Wisconsin

Preliminary Stages of Organization

- New York

States in which the Commissioner has received information on plans but has taken no steps toward activation.

- Delaware (Found no availability problem)
- Mississippi (Found no availability problem)

Twenty-six states have instituted a Market Assistance Program for products liability. Several states, including Arkansas, Conn., Illinois, Maine, Minn., Penn., S.C., and Wisconsin, are showing signs of greatly reduced activity over the past couple of months. One state, New York, is in the preliminary stage of organizing. A meeting with the Superintendent is scheduled for June 7th.

The Missouri MAP is at the stage of organizing the subcommittees. The Insurance Department has asked several companies writing product liability insurance in Missouri to contribute funds for the initial setup. The companies have refused. Application fees will be set at $150. Pat Lilly of Gulf Insurance Company in Kansas City will be the chairman.

Arizona has had a MAP in operation for some time but the activity has been minimal. The Insurance Department would like to reactivate the committee and structure it after the California MAP. To date, the committee has placed three risks. The product liability "problem" has been characterized as "not serious" by the Department. The MAP has been advertised but the number of applications has been very small with most complaints concerning price rather than availability.

The State of Washington has within the last month instituted a MAP with Mr. Larry Kibbee of the Washington Insurance Council in Seattle as the coordinator.

South Dakota has had a M.A.P. for some time. They received 2 applications of which 1 is pending and the other found a market. Ralph Benson of the Independent Insurance Agents is the committee coordinator.

Rhode Island M.A.P. was never formalized and has practically no activity at all. Louisiana has recently been activated and there is very little activity at this time.

ARKANSAS

Executive Committee

Chairman: Jim Wilson — Fireman's Fund Insurance Company
Marvin Maurras — Atkins Insurance Agency
Jack Callaway — St. Paul Companies

Industry Advisory Committee

USF&G Company
St. Paul Companies
Fireman's Fund Insurance Companies
Travelers Insurance Company
Home Insurance Company
Northwestern National Insurance Company
New Hampshire Insurance Company
Employers Insurance of Wausau
Independent Insurance Agents of Arkansas, Inc.
Arkansas Insurance Department
Professional Insurance Agents of Arkansas

3/1

2 applications to date.

returned to producers with marketing suggestions. Was not followed up by producers.

no further requests since inception of plan.

3/23/78

No applications.

CALIFORNIA

Executive Committee

Chairman:	Joseph Shakespeare	Aetna Life & Casualty
Vice Ch :	Jaan Kaiges	Employers
	Schuler Stine	Liberty Mutual
	Anthony Raia	St. Paul
	Mathew Dunne	Industrial Indemnity
	Eugene Allen	Harbor Insurance Company
	Thomas Olsen	California Farm Insurance Company
	Melville Windle	Transamerica

5/10/78

They have received approximately 34 applications but have received about 2,000 application requests.

CONNECTICUT

Products Liability Policy Committee

Chairman:	Lyman J. Baldwin,	The Hartford Insurance Group
	Oliver J. Patrell,	Aetna Life & Casualty
	H.L. Kennicott,	Kemper Insurance Co.
	John W. Purkis,	Liberty Mutual
	Roger J. Fisher,	The Travelers Insurance Co.

Products Liability Underwriting Task Force

Chairman:	Vail K. Haak, Jr.,	The Travelers Insurance Co.
	Frank W. Barry, Jr.,	Aetna Life & Casualty
	James B. Rafferty,	The Hartford Insurance Group
	John W. Maloney,	I.I.A.C.

Products Liability Plan Task Force

Chairman:	Stephen I. Martin,	The Hartford Insurance Group
	Robert L. Hill,	Aetna Life & Casualty
	Francis C. Garber, Jr.,	The Travelers Insurance Co.

In its 6 months of operation to date they have not had to use the reinsurance program for any risk. They have quoted on two, one of which found a better price elsewhere and the other is still pending.

In the first two weeks of its operation 165 complaints were considered by the committee only 5 had availability problems.

7/10

Since February 1, 1977, when the Connecticut M.A.P. was formalized there have been 69 risks (thru June 30th). Sixteen have been returned to the agent for either placement or more information. Twenty-four have been written by company in agent's office or by the present carrier. Five are in review by excess house. Three have been written by excess house. One was an out of state risk referred to another local M.A.P. Thirteen were forwarded to the underwriting committee and were either placed with the present company (6 risks), quoted thru reinsurance (2 risks) or declined (4 risks). Four risks are presently in review at the M.A.P. office.

Since February there have been 4 bulletins sent to agents, 5 educational meetings and 7 public speaking engagements by M.A.P. staff and technical committee.

9/10

The totals to date are:

86 applications.
13 returned to agent for either placement or additional information.
34 written by company in agent's office or by present carrier.
2 in review by company in agent's office or by present carrier.

CONNECTICUT

15 in review by excess house.
6 written by excess house.
1 out of state referred to local M.A.P.
12 forwarded to underwriting committee of which 6 have been placed with present company, 2 quoted thru reinsurance and 4 have declined offers.
2 in review at M.A.P. office.

11/28

100 applications
21 returned to agent for either placement or additional information.
37 written by company in agent's office or by present carrier.
2 in review by company in agent's office or by present carrier.
12 in review by excess house.
6 written by excess house.
1 out of state risk referred to local M.A.P.
13 forwarded to underwriting committtee of which 6 were placed with present company, 2 quoted thru reinsurance and 4 have declined offer.
3 in review at M.A.P. office.

5/12/78

118 applications
54 returned to agent for either placement or additional information.
40 written by company in agent's office or by present carrier.
5 in review by company in agent's office or by present carrier.
17 in review by excess house.
11 written by excess house.
1 out of state risk referred to local M.A.P.
15 forwarded to underwriting committee of which 6 were placed with present company, 2 quoted thru reinsurance and 4 have declined offer.
2 are in review at M.A.P. office.

ILLINOIS PRODUCTS MARKET ASSISTANCE PLAN

Advisory Committee

Chaired / Jointly	Vincent T. Reagen,	Aetna Life & Casualty Co.
	John T. Kelly,	Corroon & Black of Illinois, Inc.
Secretary	Thomas F. Reynolds,	Illinois Insurance Information Service
	AMIA	
	NAII	
	AIA	
	Richard D. Rogers,	Department of Insurance
	Adolph Green,	Department of Insurance
	David A. Bowers,	CNA Insurance
	Richard L. Moll,	CNA Insurance
	Laura Sullivan,	State Farm Mutual Automobile Insurance Co.
	Kenneth F. Provost,	Travelers Insurance Co.
	Robert A. Garwood,	Kemper Insurance Cos.
	Tom Thilman,	Chicago Board of Underwriters
	Bruce W. Slaughter,	Chubb & Son, Inc.
	Bob Slaughter,	Marsh & McLennan, Inc.
	Ed Mack, III,	Mack & Parker, Inc.
	C. K. Johnson,	C. K. Johnson & Assoc.
	Gordon S. Hall,	Alexander & Alexander
	John M. Shaffey,	Lord, Bissell & Brook

Producers Subcommittee

Marsh & McLennan, Inc.
Corroon & Black of Illinois, Inc.
Independent Agents of Illinois
An excess broker representative to be named later

Underwriters Subcommittee

CNA Insurance
Kemper Insurance
Hartford Accident and Indemnity
Travelers Insurance Company
An excess writer
A leading mutual writer

Drafting Subcommittee

Bruce Slaughter,	Chubb & Son, Inc.
Edward Mack, III,	Mack & Parker

Became operational on May 4, 1977, there were 15 applications filed in the first 3 days.

8/15

74 applications have been received since May 1, 1977. Each application received was accompanied by a $150 fee. All but five of the applications have been acted on by the Producers Sub-Committee. To date, products liability insurance has been placed for five of the applicants. Sixteen other application files have been closed by the committees. Two of these recived an educational answer; 11 had quotes which were determined to be reasonable in today's market conditions; 2 were placed elsewhere

and one could not be helped by M.A.P.-Illinois. Forty applications are in one stage or another of processing by the Producers Sub-Committee. Eight are being handled by the Underwriting Sub-Committee.

9/15

88 applications have been received since May 1, 1977. Products liability insurance has been placed for five of the applications. 19 other applications have been closed with an educational answer. Several of these had quotes which were determined to be reasonable in today's market conditions. 2 were informed that M.A.P. - Illinois would not be able to be of assistance in placing products coverage. 6 applicants were able to place coverage elsewhere without the assistance of M.A.P. - Illinois. 27 applications are in process in the Producers Sub-Committee. 19 applications are being handled by the Underwriting Sub-Committee.

10/7

93 applications have been received since May 1, 1977.
7 have been placed and consequently closed.
28 have received an educational answer and have been closed.
13 have been closed with either no help or have been placed elsewhere.
22 are in the producers Subcommittee.
21 are in the underwriters Subcommittee.
2 have just been received and have not been acted upon yet.

12/8

104 applications have been received.
quoted - accepted - 7
quoted - open - 11
quoted - declined - 8
assistance provided - 34
at the producers sub-committee - 29
at the underwriting sub-committee - 3
unable to assist type of product - 3
unable to assist - incomplete information and/or lack of cooperation - 8
withdrawn - 1

2/17/78

106 applications have been received
quoted - accepted - 11
quoted - open - 5
quoted - declined - 11
assistance provided - 39
at the producers sub-committee - 20
at the underwriting sub-committee - 6
unable to assist type of product - 3
unable to assist - incomplete information and/or lack of cooperation - 8
withdrawn - 3

4/1/78

109 applications
quoted accepted - 11
quoted open - 5
quoted declined - 11
assistance provided - 42
in producers subcommittee - 20
in underwriters subcommittee - 7
unable to assist type of product - 3
unable to assist uncomplete information
or inadequate assistance by the producer - 7
withdrawn - 3

5/1/78

111 applications
quoted accepted 12
quoted open - 5
quoted declined - 12
assistance provided - 43
in producers subcommittee - 9
unable to assist type of product - 3
unable to assist uncomplete information
or inadequate assistance by the producer - 9
withdrawn - 3

KANSAS

Kansas Insurance Advisory Committee

W. C. "Bill" Bock - Royal Globe - Chairman
Russell M. Caughron - Aetna Life & Casualty - Vice Chairman
John Alexander - Independent Insurance Agents of Kansas - Secretary
Steve Lindell - Hartford Insurance Group - Chairman
James D. "Jim" Dinwiddie - United States Fidelity & Guaranty Co.
Donald J. "Don" Jones - St. Paul Fire & Marine Insurance Co.
Robert E. Schilling - Employers Insurance of Wausau
Everett H. Hosford - Commercial Union Insurance Co.
Irvin C. Corder - Home Indemnity Co.
John H. Schuth - Liberty Mutual Insurance Co.
Robert J. "Bob" Morhiser - Insurance Company of North America
Homer H. Cowan, Jr. - The Western Companies
Paul L. Rundstrom - Professional Insurance Agents of Kansas, Inc.

Underwriting Subcommittee

Steve Lindell - Hartford Insurance Group - Chairman
Other members have not yet been selected.

They have received 5 applications. Two had coverage and the other 3 are presently being looked into by the committee.

8/23

Since its inception the Kansas M.A.P. has received 34 applications. Eight have been closed because either insurance is available, they failed to complete the application or they found coverage on their own. Two risks received quotes. Three risks were placed. Nineteen are still pending.

9/27

3 more risks have been closed. 2 recived quote and 1 found coverage on its own.

9/29

Three additional applications have been submitted.

10/4

2 applications have been closed. 1 risk received a quote which he rejected as too high (0.2% of sales). The other risk has coverage in another state.

11/14

3 applications received. 1 found coverage through the M.A.P. 1 is not a manufacturer nor involved with a completed operation exposure. Possible coverage under policy of primary supplier of ingredients. 1 applicant still pending.

1/12

1 applicant placed. Reinsured through a percentage basis with 15 companies participating.

The rest are in one state or another of finding a home.

2/1/78

98 applications

coverage placed through M.A.P. - 63
coverage declined - 6
applicant withdrew application - 3
uninsurable risks - 2
applications returned because of incomplete
information - 24

MAINE

Member Organizations
Travelers
Maine Bonding & Casualty Co.
Liberty Mutual
Kemper
Independent Insurance Agents of Maine
Independent Mutual Insurance Agency of New England
Maine State Chamber of Commerce
AMIA
AIA
AIM
Aetna Casualty & Surety
American Mutual
Fireman's Fund
New Hampshire Insurance
St. Paul Fire & Marine Insurance Co.
Harford Group
Campbell Fryson & Noyes

Advisory Committee
Travelers
Maine Bonding & Casualty Co.
Liberty Mutual
Kemper
Independent Insurance Agents of Maine
Independent Mutual Insurance Agents of New England

There have been 5 applications to date (May 9, 1977). Two risks have been placed by their own agents and a third is expected to also find his own coverage. A fourth risk was found not to have an availability problem but an affordability problem. The fifth risk was seeking umbrella coverage and the committee did not feel that it was part of their function and have therefore declined to look at it.

8/10

Maine has approximately a dozen applications. Of these one risk has been difficult to place. It has been referred back to the original insurer who said they may write it again. If this is not worked out, a reinsurance setup may be used for this risk. All of theother risks have found a market in the surplus lines.

10/4

No applications submitted last month.

5/11/78

Very little activity. There was one application which later declined the quote.

MASSACHUSETTS

Advisory Committee

Chairman:	John W. Purkis	Liberty Mutual
	James C. Morrow	Liberty Mutual
	Patrick McKeever	Liberty Mutual
	John E. Lundy	Commercial Union
	Roger J. Fisher	Travelers
	James D'Agostino	Travelers
	John D. Crosby	Employers of Wausau
	Jean T. Gorman	Aetna Life and Casualty
	James Sheeran	Aetna Life and Casualty
	Michael J. Sabbagh	Massachusetts Department of Insurance
	E.H. Rosenberg	Retort Inc.
	Patricia B. Maxwell	Retort Inc.
	John Gould	Maurice Saval
	Joseph Falcone	Fort Hill Agency

They are presently in the organizational stages and expect to become operation in a week or two.

8/10

Massachusetts has no producers committee because the producers are wary of their legal position and are awaiting appointment by Commissioner Stone.

Since July 1, 35 risks have contacted the program:

- 7 did not file an application and have not contacted the committee.
- 3 have to file applications.
- 6 were sent back to their last carrier for reconsideration.
- 1 received an offer fro its previous carrier.
- 2 have coverage available.
- 1 contacted to see if interested in coverage on a pooling basis.
- 4 placed in open market.
- 7 hopeful of being placed in open market.
- 1 uninsurable risk - (manufactures toy guns that can shoot real bullets).
- 3 have not been worked on yet.

9/26

67 applications:

- 15 resolved - either quoted or placed.
- 4 returned - not eligible for M.A.P.
- 7 pending additional information.
- 1 quote open - no response.
- 1 application in process of being placed.
- 3 are in underwriting committee being rated.
- 9 new applications not yet processed.
- 4 application just distributed.
- 1 application incomplete

5/1/78

98 applications

5 are pending in the underwriting subcommittee
93 have received final action of which 63 were
found coverage and the remaining 30 were
either quoted or placed in the surplus market.

MICHIGAN

Industry Advisory Committee

	Name	Affiliation
Chairman:	James M. Coates, Jr.	Fireman's Fund American Insurance Company
	Arnold Leonard	Travelers Insurance Company
	Allen Thompson	U.S.F.& G.
	Paul Middlekauff	Michigan Mutual Insurance
	Lowell Tornow	Employer's Insurance of Wausau
	Dale Bohm	Professional Insurance Agents of Michigan
	David Fleming	Independent Insurance Agents of Michigan
	Jack Butterick	Independent Insurance Agents of Michigan
	Bill Goodson	Independent Insurance Agents of Greater Detroit
	Richard Page	Auto Owners Insurance Company
	Joseph Marcellin	Hartford Insurance Company
	George McManus	Insurance Company of North America

Agents Committee

Name	Affiliation
Arthur Judson	Frank B. Hall
Anthony E. Abaid	Braun & Braun
Chas. A. McAlear	McAlear & Associates
John Meier	M & M
W. Goodson	IIAGD Detroit

Underwriters Committee

Name	Affiliation
Fred W. York	Employer's Insurance of Wausau
Joseph Sokoly	Fireman's Fund American Insurance Company
Tom Martin	Travelers Insurance Company
Jack Bauer, Jr.	U.S.F.& G.
Donald E. Smith	Michigan Mutual Insurance Company

9/1

Michigan has received 65 applications.

29 are in the marketing committee.
20 are in the underwriting committee.
8 are in the reinsurance committee.
4 are in the appeals committee.
1 has been placed in the surplus market.
2 have been returned as ineligible.
1 has been returned because insurance is available.

9/29

Met with several members of Connecticut - M.A.P. to discuss approaches to placing risks. M.A.P. - Michigan sent a letter to the president of each company writing product liability insurance in the state relating the seriousness of the situation. To date 5 risks have been placed with several companies complying with the letter.

MICHIGAN

11/14

There are now more than 100 applications.

10 have been quoted.
47 are in process of consideration
4 are in the newly formed appeal committee.

The application fee is now $50 and held at that figure by request of the Insurance Commissioner due to expenses Michigan - M.A.P. has asked participating companies for a $700 fee.

12/7

Applications received 104

3 applications returned for incomplete information.
84 applications currently pending.
13 applications received final action.
2 coverage placed through M.A.P.
6 coverage found elsewhere.
5 denied coverage by M.A.P.

5/15/78

139 applications
27 placed
18 with standard companies
9 with surplus/excess
18 closed (withdrawn or declined offer)
19 are in committee
46 are assigned and are currently being worked upon
23 have quotes outstanding

MINNESOTA

Executive Committee

B. Flanders	Fireman's Fund
T. Hunt	The St. Paul
B. Terry	Employers of Wausau
J. Schmidt	Federated
B. Mulligan	INA Re.
F. Cambell	Travelers
D. Otto	Hartford

9/1

Minnesota M.A.P. has started operation on 8/15. They have had 37 inquires but only 1 application to date ($75 application fee).

9/15

62 applications.

6 were forwarded to advisory sub-committee.
1 returned for additional information.

10/14

A total of 77 applications were requested. Of this total 12 have been completed and returned.

Disposition of the 12 applications:

4 are in review by present carrier.
3 are in review by excess house.
2 forwarded to underwriting committee.
1 declined assistance.
2 are in review at M.A.P. office.

11/14

Trouble with agents - say companies not cooperating in that they are not taking risks without rest of business. Letter sent to home offices asking for better cooperation.

90 applications.
14 applications received and forwarded to advisory sub-committee.
5 in review by company in agent's office or by present carrier.
2 in review by excess house.
7 forwarded to underwriting committee of which 2 were placed with present company, 1 was quoted and 3 were written thru reinsurance arrangement and 1 declined assistance.

MINNESOTA

2/16

118 applications requested and sent.

22 applications received and forwarded to advisory sub-committee.

applications pending - 9

risks placed
admitted carriers - 1
non-admitted carriers - 5

quotations outstanding - 2

quotations declined by insured - 1

applications withdrawn - 1

declined assistance - 3

4/17/78

120 applications requested and sent.

25 applications received and forwarded to advisory sub-committee.

applications pending - 6

risks placed
admitted carriers - 2
non-admitted carriers - 7

quotation outstanding - 1

quotation declined by insured - 3

applications withdrawn - 2

declined assistance by M.A.P. - 4

5/15/78

No applications during months of April-May.

NEBRASKA

Advisory Committee

Robert J. McMickell	Aetna Casualty & Surety
Orville Stuart	Union Insurance Company
Kent Cresswell	Hartford Insurance Company
Keith McGrath	Traveler's Insurance Companies
Neil Meisbach	H. L. Patterson Company
Leo Beck	Alexander & Alexander
Thomas F. McGowan	Foster-Barker Company
M. Berri Balka	Director of Insurance

5/11/78

5 applications to date. Three have been resolved with the other two pending. All applicants have a market but consider the price not reasonable.

NEW HAMPSHIRE

Products Liability Market Stabilization Committee

George Presse	Globe Manufacturing Company
Robert Lown	Greenerd Press & Machine
Philip Presley	Former Chief Actuary for the New Hampshire Insurance Department
Robert Sanborn	New Hampshire Insurance Company

Underwriting Committee

Robert Sanborn	New Hampshire Insurance Company
John J. Alachnowicz	The Hartford Insurance Group
Norman Champagne	Attorney
Franklin Hoskin, Jr.	Peerless Insurance Company
John Lundy	Commerical Union Assurance Company
James Morrow	Liberty Mutual Insurance Company

There were 25 risks submitted to the insurance department, of which 10 ended up in the stabilization committee. Six were quoted. Of these six, three are binding. The other four companies have either declined or are in a state of limbo.

7/10

25-30 risks have been submitted and only 12 of these reached the Stabilization Committee, the remainder were either declined, remained with existing carrier or found another market.

Of the 12 risks submitted to the Committee 7 have been or are in the process of being quoted with the remaining 5 declined for various reasons.

7/15

A meeting was held to solicit additional industry input in locating voluntary sources of coverage for a greater number of risks. Mr. Sanborn of the New Hampshire Insurance Groups would contact Commissioner Whaland with a list of names submitted by the insurance companies from which an underwriting committee would be appointed.

9/26

The committee has placed 4 applicants. One was cancelled and 3 are pending. The New Hampshire - M.A.P. has had almost no applications during the past couple of months. This is attributed to the large commission (10% or $500 whichever is less). Also they have had success in placing risks by dealing directly with the home office of the insurers.

11/22

Total number of requests for information about M.A.P. - approximately 60.

Applications received - approximately 20
returned for incomplete information approximately 12
applications pending - 2
placements through M.A.P. - 6

5/10/78

Very little activity.

New Jersey

Advisory Committee

Mr. Cavanaugh	AEtna
Mr. Adams	Johnson & Higgins
Mr. Kemper	Kemper
Mr Mastowski	Western World
Mr. Philips	Chubb & Son
Mr. Purkus	Liberty Mutual

Underwriting Subcommittee

Mr. Doyle	IIAA of N.J.
Mr. Lieb	IIAA of N.J.
Mr. Borrus	IBA of N.J.
Mr. Gesner	IBA of N.J.
Mr. Newbury	Surplus writer
Mr. Walsh	Surplus Writer

10/3

They have received 17 - 20 risks.

5/15/78

Practically no further activity. The committee has taken care of most if not all of the applicants to date.

OHIO

Advisory Committee

Chairman:	Kenneth E. DeShetler	Nationwide Insurance Companies
	Court Hall	Professional Insurance Agents
	Donald S. Keck	Shelby Mutual Insurance Company
	Lawrence C. Moddy	Cincinnati Insurance Company
	Donald W. Young	Alexander and Alexander Insurance Agency
	Roswell P. Ellis	Insurance Federation of Ohio
	Cornelius Halbert	Travelers Insurance Company
	William Kientz	Kientz and Company
	Paul Paxton	Wohlreich and Anderson Agency Inc.
	Richard O. Welsh	Westfield Companies
	Douglas N. Avery	Independent Insurance Agents Association of Ohio

Press Committee

Ros Ellis
Paul Paxton
William Kientz

Application Design Committee

Doug Avery
William Kientz
Don Young
Don Keck

Market Roster Committee

Richard Welsh
Larry Moody

As of 1-19-78 the Ohio plan has received 66 applications for placement or assistance. Of these applicants, 30 risks have been placed.

3/10/78

72 applications
- quotations - 39
- placed - 10
- declined assistance - 7
- unable to quote type of business - 4
- pending - 12

PENNSYLVANIA

Underwriters' Sub-Committee

Chairman:	Ralph H. Platts,	Reliance Insurance Company
	Robert Lewis	General Accident Insurance Company
	Fred McLemore	Insurance Company of North America
	Thomas J. Roraback	Hartford Insurance Company
	John S. Webster	FMA Insurance Company

Producers' Sub-Committee

Chairman:	Patrick Gilmore	March & McLennan, Inc.
	Frank Armstrong	Paul M. Garrett Agency, Inc.
	William C. Bloomstine,	Insurance Management Company
	Jay Lavenson	Harlan Incorporated of Pennsylvania
	Vincent A. Rutledge	Frank B. Hall, Inc.
	Irvin Salzman	Delaware Valley Underwriters
	W. Beaumont Whitney III	Alexander & Alexander, Inc.
	Kenneth Wolfe	Tri-State Mutual Agents Association

8/5

Pennsylvania has an Insurance Commissioner Product Liability Advisory Committee in operation since the beginning of May. They have received one application which was essentially an affordability problem and is being placed through the producer committee. There have been requests for applications but with the one exception above none have been filed yet (there is an application fee of $150).

9/20

8 applications received by Producers Subcommittee to date.
4 applications received a quote through the subcommittee.
4 applications are in various stages of negotiations.

The Committee has received many telephone calls as to its function. This will be accomplished in part by educational meetings of the producers and agents in the state.

3/1/78

17 risks
working on - 3
didn't accept - 2
to underwriting committee - 1
have been placed - 11

5/11/78

19 applications
closed - 13
new - 2
at underwriting committee - 1
quoted no reply - 1
declined offer - 2

SOUTH CAROLINA

Advisory Committee

Chairman:	John W. Lindsay	Commissioner of Insurance
	Mrs. Coe F. Hankinson	Shakespeare Company
	Edward R. Lloyd	Dan River Inc.
	William S. Phifer, Jr.	Crawford Sprinkler Company
	William Barnette	Liberty Mutual Insurance Company
	Jack Snedecor	Insurance Company of North America
	Glenn R. Torrence	Aetna Life and Casualty Company
	Robert E. Bowden	Seibels, Bruce & Company
	T. Russell Rooney	Rooney and McArthur Insurance Agency
	Earl E. Walker	John Henry Dukes Insurance Agency

Producers Sub-Committee

Chairman:	Robert E. Bowden	Seibels, Bruce & Company
Vice Ch :	Mrs. Coe F. Hankinson	Shakespeare Company
	T. Russell Rooney	Rooney and McArthur Insurance Agency
	Edward R. Lloyd	Dan River, Inc.
	Harris Morriss	Grier and Company
	Earl E. Walker	John Henry Dukes Insurance Agency
	James E. Cady	Hewitt-Coleman and Associaties
	Jeff Folley	Travelers Insurance Company

Underwriter Sub-Committee

Chairman:	William Barnette	Liberty Mutual Insurance Company
Vice Ch :	Glenn R. Torrence	Aetna Life and Casualty Company
	William S. Phifer, Jr.	Crawford Sprinkler Company
	W. T. Cox	Hartford Insurance Group
	Frank Dana	Dana Insurance Agency
	Jack Snedecor	Insurance Company of North America
	Bill Fairey	U.S. Fidelity and Guaranty

5/11/78

For the approximate year of operation the committee has had 1 application which was an affordability problem. It was deemed that the price quoted was satisfactory for this risk.

TENNESSEE

Advisory Committee

John Gilbert	Armistead, Miller & Wallace Corporation
Oran Ward	E. H. Crump Company of Nashville
Roger Smith	Roger Smith Insurance Agency
Clifford Love	Cooper, Love and Jackson Insurance Company
Leonard Issacs	U. S. Fidelity & Guaranty Company
James Busby	Aetna Casualty & Surety Company
Charles Myers	Travelers Indemnity Company
Burford Dreaden	Tennessee Farmers Mutual Insurance Company

5/26/78

The Tennessee M.A.P. had its first organizational meeting not long ago and anticipates that it will be ready for operation after the next meeting on May 30th. There has not been a severe crisis in the products line in Tennessee but there is from time to time a risk that may have some difficulty finding a market.

The Department sees the M.A.P. as a cooperative venture between the insurers and the department to help solve a few problems without having to go to the legisltors.

TEXAS

Members

	Name	Affiliation
Chairman:	Bill Huff,	Employer's Casualty Co. of Texas
	J.D. White,	American General Life Insurance Co.
	Charles Jones,	Gulf Insurance
	Robert G. Bezucha,	Hartford Insurance Group
	Hank Wasko,	Crum & Foster Insurance Cos.
	L.A. Smith, Jr.,	Firemens Fund Insurance
	Jerry H. Roy,	Travelers Insurance Company
	Nolan Kelso,	Kemper Insurance Company
	Joseph Olson,	USAA
	Al Gabbard,	General Reinsurance Corporation
	Robert Murphy,	Ehrman, Murphy & Company
	Dan Ross,	Ross Insurance Agency
	Charles C. Woodward,	SWH, Inc.
	Herbert A. Yarbrough, Jr.,	Stokes-Yarbrough & Searcey Agency
	Jimmy Braniff, III,	James J. Braniff & Company
	Betty Turner,	Frank Siddon's Insurance Agency
	Forrest McPhaul,	Southwest/International Underwriters Managers Inc.
	Bill Gainer,	Hammerman & Gainer
	Earl Calkins,	Mustang Tractor and Equipment Co.
	Larry D. Willmann,	Sulta Manufacturing Company
	Jim Boyle,	Texas Consumers Association

Executive Committee

Name	Position
William H. Huff, III,	Chairman
Nolan Kelso,	Vice Chairman
Evelyn Ireland,	Recorder
Herbert Yarbrough,	
Hank Wasko,	
Bill Gainer,	
Jim Boyle,	
Larry Willmann,	
Robert Murphy,	

Producers Subcommittee

Name	Position
Robert Murphey,	Chairman
Herbert A. Yarbrough,	Vice Chairman
Earl Calkins, Sr.,	
Dan Ross,	
Milton Troxell,	
Betty Turner,	
Jimmy Braniff, III,	
Charles C. Woodward,	

TEXAS

Underwriters Subcommittee

Hank Wasko,	Chairman
Nolan Kelso,	Vice Chairman
L.A. Smith,	
Jerry H. Roy,	
Robert G. Bezucha,	
Milton Troxell,	
J.D. White,	
Art Werden,	
Forrest McPhaul,	

Research Subcommittee

Bill Gainer,	Chairman
Larry Willmann,	Vice Chairman
Joseph Olson,	
Jim Boyle,	
Charles C. Woodward,	
Jerry Roy,	
L.A. Smith, Jr.,	
Earl Calkins,	

9/1

An organizational meeting was held on August 19th. The chairman appointed a sub-committee to draft a plan of operation based on the Illinois M.A.P.

9/26

A proposal to include a member of the Trial Lawyers Association and a member of the Defense Lawyers Association on the Research Committee has been made.

3/1

Approximately 16 applications to date some of whom had quotes. There seems to be very little action. The M.A.P. has been advertised to many agent and manufacturing associations. This procedure will be tried again.

5/11/78

About 25 applications of which all have been given quotes. Approximately half have been placed. Three risks which may be very hard to place.

VIRGINIA

Industry Advisory Committee (temporarily acting as Screening Committee)

Chairman:	T. L. Bondurant	Ætna Casualty & Surety Co.
	Jeff C. Wells	The Hartford Fire Insurance Co.
	Percy C. M. Butler	Liberty Mutual Insurance Co.
	W. Craig Heston	Utica Mutual Insurance Co.
	Philip H. Castellon	Nationwide Mutual Insurance Co.
	Otis W. Nuckols	Virginia Farm Bureau Mutual Ins. Co.
	Donald T. Zimmerman	State Farm Insurance Companies
	E. P. Kehoe	Johnson & Higgins of Virginia, Inc.
	Cushman L. Andrews	Marsh & McLennan of Virginia, Inc.
	Wm. R. Walker, Jr.	Mutual Insurers, Inc.
	Richard G. Duncan	Richard G. Duncan & Associates
	Garland L. Haselwood, Jr.	Bureau of Insurance

Legislative Liaison Committee

Chairman:	Percy C. M. Butler	Liberty Mutual Insurance Co.
	Otis W. Nuckols	Virginia Farm Bureau Mutual Ins. Co.
	Donald T. Zimmerman	State Farm Insurance Companies
	Wm. R. Walker, Jr.	Mutual Insurers, Inc.
	Jeff C. Wells	The Hartford Fire & Insurance Co.

Underwriting Committee

Warren S. Carter Alt: Mrs. Judy Ladd	Harleysville Insurance Companies
Burton A. Lindemann Alt: G. E. Thurmond	Liberty Mutual Insurance Company
P. H. Castellon Alt: J. R. Kettering	Nationwide Mutual Insurance Co.
Tim Pope Alt: Allen Prise	Utica Mutual Insurance Co.
Jeffrey Maas Alt: John Fraizee	Commercial Union Company
David D. Loury Alt: None	The Hartford Accident & Indemnity Co.
Thomas N. Potter Alt: W. C. Hobson	Kemper Insurance Companies
Larry Lawson Alt: Warren Bessler	The St. Paul Fire & Marine
James F. McInteer, III Alt: None	Virginia Farm Bureau
Terry L. Caler Alt: Frank Nalls	Crum & Forster Insurance Companies
W. Mulvaney Alt: David V. Fewell	The Home Insurance Company
E. M. Pennington Alt: E. Murphy	Ætna Life & Casualty
Jeanne McFarland Alt: Evan Rees	Ætna Insurance Company

35-992 O - 79 - 11

-2-

Underwriting Committee (contd)

Max L. Norton Alt: Conrad Simon	The Travelers Insurance Co.
Marion L. Hall Alt: None	Reliance Insurance Co.
Michael J. Donaghy Alt: L. T. Berry, Jr.	United States Fidelity and Guaranty Co.
Andy Vandersloot Alt: None	Continental Casualty
Mona V. Olson Alt: None	Insurance Company of North America

1/19/78

Since its inception in July 1977, 11 applications have been received. Of these, 2 have been placed through M.A.P.: 1 referred to present carrier in the hope of providing products liability coverage; 2 applications returned - incomplete; 5 referred to surplus markets and excess lines market and 1 pending.

3/1/78

3 or 4 applications in last month. Disposed of by referring to the surplus market. 1 is still pending. Total number of applications to date is 15-18.

WISCONSIN

Industry Advisory Committee

Members and/or Alternates

Jerry Vertin,	Sentry Insurance
Tom Hunt,	St. Paul Fire & Marine Insurance Co.
John McNeil,	General Casualty Company of Wisconsin
Howard A. Grauff,	CNA Insurance Group
R. J. Wendorff,	Employers Insurance of Wausau
Carl Hertting,	Employers Insurance of Wausau
Don Messmer,	Northwestern National Insurance Company of Milwaukee, Wisconsin
Robert A. Garwood,	Kemper Group
Paul H. Mast,	Independent Insurance Agents of Wisconsin
Robert Jarts,	Independent Insurance Agents of Wisconsin
Don Rust,	American X/S Underwriters
Mel Engfer,	Frank B. Hall & Company
Robert Toerpe,	Frank B. Hall & Company
J.David Rowland,	CRB Insurance Agency
Karl Gengler,	Gengler-Barr & Associates, Inc. & Wisconsin Independent Mutual Agents
L. N. Hannes,	Office of the Commissioner of Insurance - State of Wisconsin
Allen Gruendsen,	American Family Mutual Insurance Company
G. Robert Perry,	St. Paul Fire & Marine Insurance Company
H. L. Kennicott,	Kemper Group
D. K. Holliday,	Sentry Insurance
E. Stony Steinbach,	Wisconsin Independent Mutual Agents

Underwriting Subcommittee

	Donald Messmer,	Northwestern National Insurance Co.
Alt:	Marv Abraham,	Northwestern National Insurance Co.
	Jack Swartz,	CNA Insurance
	Bill Thornquist,	Travelers
Alt:	Gerald E. Jossart,	Travelers
	Jerry Vartin,	Sentry Insurance
	Carl Hertting,	Employers Insurance
	Ex Officio Members	
	Donald Rust,	American X/S Underwriters

Producer's Subcommittee

American X/S Underwriters - Chairman
Frank B. Hall and Company
CRB Insurance Agency
Gengler-Barr and Associates, Inc.

WISCONSIN

Insurance Company Technical Subcommittee

Employers Insurance of Wausau - Chairman
Northwestern National Insurance Company of Milwaukee
CNA Insurance Group
Sentry Insurance
Travelers

Executive Committee

Sentry
American X/S Underwriters
Employers Insurance of Wausau
Independent Insurance Agents of Wisconsin
Representative from the Office of the Commissioner of Insurance

The Wisconsin plan as of May 9th has received 59 calls; 22 from agents, 34 from individual risks, 2 from lawyers. To date however, they have received only 29 applications. Five of these have been closed with only 2 or possibly 3 being placed through the committee. Eleven were sent to the underwriting committee and of these, 7 or 8 will be very hard to place. Ten applications are in the process of being examined and 3 applications are presently in the mail.

7/5

Wisconsin M.A.P. received 43 applications to date five of which have been placed.

A suggestion for a voluntary reinsurance mechanism has surfaced in the Wisconsin M.A.P. It is presently in the discussion stage.

9/12

61 applications submitted to the underwriting subcommittee.
A total of 28 applications have been resolved one way or another.

A reinsurance plan to be used only as a last resort will be presented at the next meeting scheduled for Oct. 18.

1/15

65 applications
41 closed
24 in various stages of being resolved by which 8 will probably be handled through a voluntary quota - share reinsurance arrangement.

WISCONSIN

2/1/78

71 applications
returned for additional information - 4
coverage placed through M.A.P. - 13
declined M.A.P. offer - 2
applicant resolved own problem - 31
pending application - 21

5/11/78

72 applications
closed - 54
pending - 18

ATTACHMENT B

INSURANCE SERVICES OFFICE

ISO is the statistical and rating organization for the property-liability insurance industry. In its capacity as a rating organization it publishes manual rates for use by its affiliated insurers. It also reviews statistics for higher limits and publishes increased limits tables. The most recent history of Bodily Injury rate changes since 1963 is as follows:

Rate Level Changes

	Countrywide Average Basic Limits Manual Rates
May 29, 1974	Classification Changes
August 1, 1975	+50.0%
August 1, 1976	+40.0%
1977	No Change

	Countrywide Average Increased Limits	
	Table A	Table B
May 29, 1974	+175%	
June 1, 1975	+62.9%	+81.1%
June 1, 1976	+ 7.1%	+10.6%
	No Change	

In order to determine rate level changes shown above, ISO analyzes the statistical data reported to it by insurers. At the present time these data reflect the experience of the manual rated classes only and do not include the product liability portion of commerical package policies. ISO has revised its statistical reporting requirements and has developed a new Commercial Statistical Plan which will result in the overwhelming bulk of product liability data being reviewed in the future.

Loss Ratio - Monoline

Although rate making detail is, at the moment, unavailable for (a) rated risks, summary data of premiums and losses are reported. For the latest available policy year the countrywide totals (Bodily Injury and Property Damage) of manual rated and (a) rated risks show that $1.47 of losses and loss adjustment expense was incurred for every $1.00 of premium paid.

Loss Ratio - Composite

The summary experience for composite rated, loss rated and large (a) rated risks also indicates an extremely adverse situation. For all of the coverages provided these risks, losses and loss adjustment expenses amounted to $2.13 for every $1.00 of premium earned!

More specific information and related statistics are provided in the "Background Report on Statistical and Rating Procedures" published by ISO in December, 1976.

Claim Cost Changes

In the actuarial analysis of data to determine future prices ISO develops a trend factor which measures the changes that have occurred in product liability claim costs in the past. Based on the standard formula used by ISO the bodily injury basic limits paid claim costs have increased 17.4% annually. For total limits the annual trend was +27.4%.

Comparison with CPI

A comparison of product liability incurred claim costs with changes in the Consumer Price Index shows that actual claim costs have far outstripped general price increases as measured by the CPI from 1965 through 1974. During that period the CPI rose 56% while Bodily Injury product claim costs rose almost 1,300%.

STATISTICAL CHANGES

Over the past 3-1/2 years ISO has taken several steps to improve and expand the data base for product liability and to increase its timeliness and responsiveness. Some of those activities are:

1. A change in statistical reporting requirements for (a) rated risks to require the reporting of exposures in classification detail.

2. A change in eligibility rules for composite rated risks to eliminate the product liability exposure from being composite rated.

3. The development and implementation of the new Commercial Statistical Plan which will provide product liability detail for commercial package policies.

CLOSED CLAIMS STUDY BY INSURANCE SERVICES OFFICE

In November 1977, ISO published a 500-page "technical analysis" of the results of its Special Product Liability Closed Claims Survey. That study included data on 24,452 survey forms that had been submitted by 23 participating companies.

The purpose of the study was to collect data for use in (1) making quantitative analysis of the causes of the current product liability problem; (2) determining what actions should be taken to prevent further deterioration of the situation; and (3) to compile a large experience base of claims data to use in evaluating legislative alternatives to the present tort liability reparations system.

Some of the more significant findings were:

- Claims closed without payment occur in one out of every three product liability claims presented. For these cases, the average economic loss was $15,464, and the average defense expense incurred by insurers was $3,121. It was not possible in this study to determine how much economic loss was recovered from other sources of payment, e.g., group health insurance, government systems, workers compensation, etc.

- Less than 1% of the B.I. claims are responsible for over 50% of the payment dollars.

- Workplace injuries which received compensation were involved in only 7% of the compensated incidents, but accounted for about one third of the combined B.I. and P.D. payments. File reviewers judged that employers would have been impleaded (i.e., along with the product manufacturer) for possible contributory negligence in half of these cases had they not been shielded from liability by workers compensation laws.

- Workers compensation subrogation liens were filed in 3% of the total incidents. The total amount sought in these liens was equivalent to about 10% of the total B.I. and P.D. payments and to 27% of the payments for workplace injuries only. File reviewers believed that workers compensation subrogation "instigated" 21% of the workplace cases (1.6% of all cases), and "partly instigated" another 13%.

- On the average, persons who received product liability B.I. payments recovered $2.40 for every $1.00 of economic loss sustained, when all sources of liability

ALLIANCE OF AMERICAN INSURERS

The Alliance, formerly AMIA, conducted a study of product liability cases closed during 1975 for amounts exceeding $100,000 in loss payments and related expenses. This survey, involving eight of their member insurers, turned up 79 such cases, 7 of which involved damage to property only. These large loss incidents generated payments and loss adjustments costs amounting to $22.7 million. The average expenditures for defendant legal fees was $20,680 per incident. Although the large-loss incidents involved a wide variety of products, over 70% were industrial products.

Although this study covered a small sample, it is significant because product liability cases involving payments of $100,000 or more, although few in number (less than 2% of total claims), account for slightly more than half of all of the dollar losses. The study results are very useful when used in conjunction with the broader, more statistically credible, ISO study which covers the total population of closed claims, including those that received no payment but involved considerable defense costs. Both studies share the following conclusions.

- the problems afflicting product liability stem primarily from bodily injuries rather than from property damage.
- industrial products generate a much greater proportion of dollars of loss than consumer products.
- although tort reform proposals are not directly addressed, the two studies include important segments of data that demonstrate that certain tort reform proposals being advocated by insurance organizations and other groups, would, if enacted, generate reductions in future product liability losses and premiums, and more importantly, provide much needed greater predictability and stability for losses in the future.
- workers compensation liens filed as subrogation claims by workers compensation carriers amount to a small percentage of total payments for products claims--about 10%. (Actually, the amounts collected are much less than this percentage because of compromises and payment of attorney fees.)

payments were taken into account. Product liability payments alone provided reimbursements averaging $1.00 of economic loss. These figures do not include payments from collateral sources such as group health insurance, social security, medicare, workers compensation, etc.

- For each $1.00 of loss, there are additional expenses of 35 cents for B.I. and 48 cents for P.D. incurred by the insurance company in defending claims.

- Food claims were paid in 56% of the B.I. incidents, but accounted for only 2% of the payments. On the other hand, industrial products involved in workplace accidents accounted for only 11% of the B.I. incidents but consumed 42% of the B.I. payments.

- Eight years after manufacture, 4% of the B.I. claims involving 10% of the ultimate payment amounts had not yet occurred. For capital good the time lapse from manufacture to occurrence is much longer (3 years or more).

- Approximately 73% and 83% of all B.I. and P.D. claims respectively, are settled without a suit being filed. Only 4% of B.I. and 3% of P.D. claims go all the way to a court verdict. The defendants win approximately 4 out of 5 cases which go to a court verdict.

- Strict liability, negligence liability and breach of warranty are used about equally as the principal theories for successful B.I. claims, but for property damage claims, negligence liability is used almost half of the time. File reviewers believe that the principal of comparative negligence only affects about 6% of the B.I. and 4% of the P.D. payments.

- Average payments received by injured or damaged parties amounted to $26,004 for bodily injury and $6,871 for property damage incidents. These averages include payments from all liability sources, but exclude collateral sources outlined above.

The complete technical analysis may be obtained from ISO for a nominal charge and a summary of the study's highlights is also available, without charge by writing:

ISO Product Distribution Division
160 Water Street
New York, New York 10038

PRODUCT LIABILITY TASK FORCE REPORT - AETNA LIFE & CASUALTY 1977

Aetna Life & Casualty
155 Farmington Avenue
Hartford, Connecticut 06156

The report is the result of an intensive two-month study of product liability by Aetna Life & Casualy Insurance Company completed in February, 1977.

The conclusions of the study are as follows:

- an availability problem exists for a relatively few business risks because of increasingly restrictive underwriting practices.
- there have been significant rate increases, especially for small businesses, between 1974 and 1976 after many years of rate inactivity.
- present statistical plans are insufficiently refined to pinpoint the precise magnitude of the product problem.
- severity rather than frequency presents the greater problem because of the effect on rating unpredictability.
- industrial product manufacturers face the greatest exposure to claims severity in part because they are subjected to repeated use over a long period of time.
- the potential for severe injuries and consequently more expensive awards is greatest for machinery type products relative to household goods.
- the inability to predict jury awards is a significant reason why insurers settle out of court.
- the elimination of traditional tort defenses accompanying the adoption of strict liability does significantly impact claim experience.

on the average, persons who receive product liability B.I. payments recover much more than the economic losses they sustain. There is evidence of much duplication of payments from sources other than product liability insurance.

companies incur substantial amounts of defense expense in successfully denying payment for one third of presented claims, and for mitigating payments for the other two thirds of presented claims.

INTERAGENCY TASK FORCE - FINAL REPORT

In 1975, an apparent problem arose in the field of product liability. A number of manufacturers and business periodicals alleged that product liability insurance had become unavailable or unaffordable. After some initial investigation, a Federal Interagency Task Force was established by the White House to study the product liability problem and report back to it on or before December 15, 1976. A report based on that document, entitled "The Federal Interagency Task Force on Product Liability Briefing Report" was released to the public on January 4, 1977. The Briefing Report was based on preliminary drafts of three independent contractor studies commissioned by the Task Force as well as pre-December 1, 1976 data and information. The independent contractor reports were in the legal, insurance and industry areas.

The full report is available from:

National Technical Information Service
U.S. Department of Commerce
Springfield, Virginia 22161

INTERAGENCY TASK FORCE - CONTRACTOR REPORT - GORDON ASSOCIATES - INDUSTRY STUDY

TELEPHONE SURVEY

Coverage

Approximately 75% to 95% of the firms in the survey carry some form of product liability coverage. Variation in coverage was dependent on the firms size rather than the product category. A significant number of the firms, 46 (14% of survey), are going without product liability insurance.

Cost of Insurance

The respondents to the survey for the most part reported product liability

coverage as comprehensive general liability (CGL). The results show that the average coverage has increased by nearly 207% during the 1971 to 1976 period. For the period 1974-1976 the increase was 119%. Most of the firms were able to estimate the cost of the product liability portion of the CGL plans. The estimated average costs of product liability coverage increased about 280% between 1971 and 1976. However the increases were greatest between 1974 and 1976 when it is estimated to have jumped 210%. The small and medium sized firms (under $100 million in total sales) had larger than average increases. The increases were two to three times as high for the nine areas specified as problem areas.

Product liability costs represented a very small percentage of sales. During 1976 the product liability coverage averaged 0.28% per $1,000 of sales with a range of 0.109% to .532%. Even in the nine product groups designated as problem areas the costs were small relative to sales. In 1976 the average costs for these "problem" areas averaged only .55% with a range of .167% to 1.11%.

Trends in Deductibles

Deductibles for combined P.D. and B.I. have increased about three times from 1971 to 1972, decreased slightly over the next three years and has increased approximately 68% between 1975 and 1976. Through the entire period, 1971 to 1976 the deductibles have increased over four times. In addition, the number of firms reporting deductibles has increased from 59 to 116 (a 88% rise). However, it is interesting to note that for the small firms the combined P.D. and B.I. deductible has decreased every year from 1971 to 1976.

Claims Experience

Overall 55.6% of all the reporting firms reported a product liability claim.

A breakdown by size of firms shows 96% of the large firms, 50% of the medium and 18% of the small firms experienced a claim during the period 1971-1976. The average number of pending claims has increased from 1971 when it was 3.5 per firm to 1976 when the average was 18.9. Several product categories show much greater increases. Power mowers have increased 675% from 6.2 pending claims per firm in 1971 to 48.1 in 1976. Likewise automotive components have jumped from 1.8 pending claims to 36.9, an increase of 1,950% over the same period. Industrial machinery had an increase of 855% (1.9 to 18.1 pending claims).

The average number of new claims per firm increased from 1971 (4.3) to 1974 (12.2) when a peak was reached. Since 1974 there has been an overall decrease but for the entire period (1971-1976) there is an increase of 130%.

The average amount of damages sought per firm in pending claims has increased 712% since 1971. The damages sought rose from $434,100 to $3,527,000 per firm. For new claims the average damages sought is $1,711,000 per firm (a 259% increase from 1971).

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35-992 O - 79 - 12

INTERAGENCY TASK FORCE REPORT

McKINSEY & COMPANY STUDY

In March, 1977 this one-volume study of product liability insurance prepared by McKinsey & Company for the Department of Commerce was published. This report was undertaken in support of the overall study conducted by the Federal Interagency Task Force on Product Liability. The consultants interviewed 141 members of the insurance community, analyzed information from approximately 3,000 underwriting files, and analyzed data provided by ISO. Several of the findings are worth noting:

1. In the eight "target" product categories analyzed, rates appeared to have increased significantly, 100-500% during 1976. But for only 20% of the cases did the current rate amount to more than 2% of sales for coverage of $500,000. In almost 50% of the individual product classifications within the 8 target categories, rates were less than 1% of sales.

2. "The most potentially fruitful area for action to curb the sudden growth in product liability insurance costs involves changing the tort liability system--restoring some of the defenses that have been lost by judicial interpretation over the past ten years, reducing friction costs such as legal fees, and setting realistic guidelines for awards."

3. As of December 31, 1975, 783 or 89% of the major U.S. underwriters of general liability coverage were ISO affiliated insurers and thus reported their data to ISO.

4. While sharp increases in product liability insurance rates have been applied to both large and small companies, the variation among companies is due more to the type of product than to the size of the company.

This study contains a great deal of data gathered from insurance company underwriting files that had never before been compiled. It is available from the National Technical Information Service (PB 263 600).

INTERAGENCY TASK FORCE - FINAL REPORT

Independent Survey of Appellate Cases

A sample of eight states was used for a concentrated detailed analysis of all product liability decisions reported in the West Publication System since 1965. Most of these reported decisions were appellate cases. Both state and federal cases were included in the analysis. It should be noted that federal courts typically apply the substantive law of the state in which the court is located. 655 cases are included in the survey of which 509 were tried in state court, the remainder in federal court.

The most frequent product class involved in a suit was the automobile (192 cases) followed by industrial type machinery (57 cases), construction and loading equipment, escalators, ladders and sacffolds, chemcials, cleaning products.

The manufacturer was a defendant in most cases (79%) with the retailer, the next most frequent (33%). Other defendants included the employer, the lessor, the installer, the wholesaler and the manufacturer's supplier. The manufacturer was also the most frequent third-party defendant.

Of the 198 cases which stated the year the product was manufactured, the median date was 1964. 17% of the cases involved a product more than 20 years old. Most automobile cases occurred shortly after manufacture. Machinery cases were spread throughout, with almost one-third occurring 10 or more years after manufacture and about 15% from products greater than 20 years old.

Work related injuries accounted for 48% of the 581 cases in which it was ascertained whether the injury was work related or not. This percentage has been relatively constant over the 1971-1976 period and has risen only slightly over the 1965-1970 period when the figure was 46%.

86% of the cases which proceeded to trial were heard by juries. Where the plaintiff was the injured party a jury heard the case 87% of the time while for

cases where the injured party was not the plaintiff a jury trial took place 62% of the time.

Most the cases alleged either design or manufacturing defects (502 cases). Failure to warn was cited in 130 cases, failure to inspect in 40 cases and an unavoidably unsafe product was alleged in 31 cases. In the product class of machinery there were 64 allegations of defective design and 28 allegations of defective manufacture. For chemical products 22 cases involved a failure to warn.

The plaintiff won 51% of the trials. A breakdown of the trials shows that the plaintiff is more likely to win in a jury trial (60%). However, for nonjury trials, the defendant prevailed in 56% of the trials. The plaintiff also won 58% of the manufacturing defect cases while the defendant won in approximately 54% of the design defect cases. Failure to warn cases were decided almost evenly with the defendant winning 51% of the trials. The period 1965-1970 shows that the plaintiff prevailed in 51% of the cases. This figure has risen slightly to 53% for the 1970-1975 period.

There is an upward trend for damages awarded from the period 1965-1970 when the award was $104,202 to 1971-1976 when the average award was $221,514. The greatest amounts of damages were recovered in cases involving machinery and automobiles.

When the statistics were broken out by individual states the findings varied. California and Arizona showed modest increases in the number of decisions between the 1965-1970 and 1970-1975 periods (16% and 25%). However New Jersey and Wisconsin showed a 211% and 167% increase respectively. While most states showed a fairly even split between plaintiffs and defendants, the plaintiff was most successful in California (58%) and Texas (63%). The defendant was most successful in Illinois (56%). California and Texas also had the highest damages awarded with Illinois having the lowest average awards.

COOK COUNTY SURVEY

Illinois Jury Verdict Reporter
Urban Ring Edition
127 North Dearborn Street
Chicago, Illinois 60602

The Cook County Survey reviews all product liability cases which were tried to a conclusion in Cook County, Illinois during the period January 1, 1970 to December 31, 1975. In all, 290 cases had been concluded of which 103 or 35.3% were found to be in favor of the plaintiff. These 103 cases accounted for a payment totaling $25,024,345. In 101 of the cases where the jury determined the award the average verdict amounted to $247,764.

A year by year breakdown of the cases offers little in the way of trends. Of note is the fact that 42% of the trials have occurred within the last two years of the survey. Also that the last year, 1975, had the highest percentage of cases in which the plaintiff had won, 43.1%. A followup to the survey shows that the percentage has increased in the 1977-1978 (midterm) period to 49.4%. the average sum awarded in 1975 although not the highest was $338,327 which constituted a 263% increase since 1970. However, this figure is biased by the inclusion of one verdict for $5 million. The average verdict becomes $144,091 if this one large award is not included.

A breakdown of the sum awarded by verdict shows that 3 cases were closed with verdicts over $2 million. In 10 other cases the award was between $500,000 and $800,000 and in 8 additional cases the award fell between $300,000 and $480,000. These twenty-one products vary in type to include a crane, an antibiotic, wall covering, sugar, punch presses and other various types of products. The product class with the most suits was machinery which made up 25% of all suits settled in 1975. Machinery also accounted for $13,907,000 or 42% of all the dollars awarded and had an average award of $496,000.

A followup to the study shows that in 1975 there were 769 new suit filings, an increase of 14% over 1974 and this has increased another 13% to 868 filings for 1976. For 1977, 991 new filings or a 14.2% gain have occurred.

An additional part of the survey covers the urban ring which is composed of the five counties adjourning Cook County in addition to a few other counties. This accounted for an additional 82 trials in which the verdict was found for the plaintiff in 40 or 48.8% of the trials. These 40 verdicts constituted $4,013,270 for an average award of $100,332. A followup shows that the plaintiff's percentage of victory has increased to 50% during the 1976-1977 court session.

ANNUAL REPORT OF THE DIRECTOR OF THE ADMINISTRATIVE OFFICE OF THE U.S. COURTS

The data shows a rise in product liability cases being filed in the U.S. District Courts during the period 1974 to 1976 when the number of cases increased from 1,579 to 3,696 as reported in the Interagency Task Force on Product Liability - Final Report.

CONNECTICUT SURVEY OF PRODUCT LIABILITY SUITS

A review of the survey will show a 29% increase in the number of product liability cases on the docket between 1974 and 1976 (587 cases and 756 cases respectively). Among cases assigned to trial, product liability cases showed an increase of 36%, while all tort cases showed an increase of only 14% and the total civil caseload showed a decrease. Reported in Interagency Task Force on Product Liability - Final Report.

SURVEY OF PRODUCT LIABILITY CASES IN THE GREATER KANSAS CITY AREA BY KANSAS TRIAL LAWYERS ASSOCIATION

This survey shows the percentage of cases in which the plaintiffs are victorious to be 36%. The average award over the nine year period, 1967-1975, was $9,850 per verdict which would probably include a $0 amount in those cases the plaintiff lost. If the $0 awards were eliminated the average would probably be much greater. Reported in Interagency Task Force on Product Liability - Final Report.

CALIFORNIA SUPERIOR COURT VERDICTS

Insurance Information Institute
400 Montgomery Street
San Francisco, California 94104

A survey of the California Superior Product Liability Court verdicts between 1972 and 1977 has shown the number of verdicts to have increased from 97 to 139, a 43% increase. During this time verdicts for the defendants have risen from 44.4% to 60%. The total amount of dollars awarded in 1972 was $19,322,336, however this includes one judgment for $14,345,074. If this one case is omitted, the 1972 figure becomes $4,977,262 and compared to the $12,629,174 awarded in 1977 shows an increase of 154%. Likewise the average award has shown a steady increase since 1972 (if the one large verdict is omitted) increasing from $93,910 to $229,621 (a 144% increase).

MACHINERY AND ALLIED PRODUCTS INSTITUTE (MAPI)

Machinery and Allied Products Institute
1200 Eighteenth Street, N.W.
Washington, D.C. 20036

MAPI survey completed in August, 1976, is composed of 210 companies representing "a broad range of industry with by the far the greatest concentration in the capital goods industries."

The survey shows that for the decade 1965-1975 the number of claims has risen 49% with 1973 as the peak year. However, the dollar value has increased through the entire period from $11,490,971 to $81,236,281 or about 610%. These figures may understate the picture somewhat. There will probably be more claims which will arise for 1975 since many claims are not reported until several years after the accident. Therefore the apparent decrease in claims since 1973 may not be accurate.

The nuisance type of claims, that is those settled for under $1,000 have been decreasing steadily since 1965 when they comprised 79% of the claims. In 1975 they made up 57% of the claims. However, claims in the range of $1,000 to $10,000 and from $10,000 to $100,000 have increased from 17% in 1965 to 29% in 1975 and from 4% to 11% respectively. In 1965 there were only 2 claims which exceeded $500,000 while in 1975 this has increased to 52 claims.

For the five year period 1970-1975 there were 16,785 claims amounting to $366,905,041 or about 95 claims totaling $2,084,687 per firm. 4,396 or 26% of the claims and $8.7 million or 2% of the total monies paid out were for claims with no court action (nuisance claims). 11,768 suits were filed seeking damages totaling $828 million. In 212 suits the plaintiff was awarded $22 million dollars for an average verdict of $104,056. Out of court settlement was reached in 1,218 claims accounting for $115,794,836 or about $95,000 per claim. 3,203 suits amounting to $114 million are still pending.

RISK AND INSURANCE MANAGEMENT SOCIETY

Risk and Insurance Management Society, Inc.
205 East 42nd Street
New York, New York 10017

370 firms responded representing large manufacturing, wholesale/distribution, retailing and services.

- premiums for primary and excess coverage increased about 200% from 1971-1975 with the largest increases occurring between 1971 and 1973.
- in 1975 the average deductible was approximately $40,000, an increase of about 200% since 1971.
- limits of liability have increased about 100%.
- it is estimated by RIMS that 60% of all claims reported in 1975 were filed against food and kindred products and rubber and plastic products.
- the number of new claims has increased from about 55 claims per firm in 1971 to 181 claims per firm in 1975.

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

National Federation of Independent Business
490 L'Enfant Plaza East, S.W.
Suite 3206
Washington, D.C. 20024

The NFIB received 1,296 responses representing small independent manufacturers spread across a broad spectrum of industries.

- product liability insurance rates are rising rapidly and firms are expecting premium increases of 50% or more.
- the number of claims in 1976 is estimated to be double that of 1972. Damages paid are also rising sharply.

Of the 177 respondent companies only 3 (1.5%) had premiums which constituted 3.0% or more of their sales. 153 or 86.4% of the companies reported premiums which were less than 1% of their sales (21 companies has premium between 1% and 2.9%).

SOCIETY OF THE PLASTICS INDUSTRY

The Society of the Plastics Industry, Inc.
355 Lexington Avenue
New York, New York 10017

The survey was mailed to the 1,100 members during the period September 15, to October 22, 1976. 366 respondents were received representing processors, material suppliers, mold and tool makers, and machinery manufacturers. The majority of companies were small and medium sized.

- primary coverage increased an average of 224% from 1970 to 1976. The largest increases have occurred in 1975 and 1976. However, the costs represent only 0.2% of sales. It should be noted that the median cost was substantially less.

- deductibles fluctuated from year to year. In 1970, 20 companies reported deductibles and by 1976 the number is 55. The average deductible increased 16% to $74,328 in 1976, however the median amount was $5,000.

- no significant changes in the limits of liability.

- 1970-1975 new claims have increased 340% while damages sought have increased 567%.

- the number of claims settled out of court has more than doubled.

- from 1970 to 1975 there have been 64 suits of which the plaintiff has won 28 or 44%. The average verdict in 1975 was $45,900.

- pending claims/suits have increased over five-fold. For 1976 the average damages sought is over $1/2 million.

CALIFORNIA SENATE SELECT COMMITTEE ON SMALL BUSINESS ENTERPRISES

Senate Select Committee on Small Business Enterprises
116 9th Street
Room 71
Sacramento, California 95814

This survey conducted in November, 1977, was responded to by nearly 400 firms located in California.

- the average annual premium increase was 225% with industrial products reporting an even greater increase.
- approximately 30% of all firms had one or more claims filed against them. The percentage was almost double for industrial products.
- a positive correlation seems to exist between the probability of a claim and the age of the firm.
- nearly 25% of the respondents indicated that they presently had no product liability insurance coverage.
- 17 firms or 6.1% of those surveyed reported they could not get insurance.

CAST METALS FEDERATION

195 firms responded of which 165 carried product liability insurance. The survey covered the period 1971 to 1976.

- insurance cost was stable from 1971 to 1974. Since 1974 costs have increased 155% but still remains well under 1% of sales (.12%).
- firms of all sizes seem to be affected.
- deductibles have doubled since 1971 to an average of $6,590 in 1976.
- the number of new claims and damages sought have risen greatly. Out of court settements have averaged $19,795. There have been 2 (out of 5) successful suits which totaled $451,000.
- pending suits/claims have also increased sharply.

Survey reported in Interagency Task Force - Final Report.

GRINDING WHEEL INSTITUTE

Grinding Wheel Institute
1230 Keith Building
Cleveland, Ohio 44115

The following is a summary by the Institute:

- respondents represent over 70 percent of the dollar volume of bonded abrasives manufactured in the United States.
- the total number of product liability claims was 75 percent greater in 1975 than in 1970. The large and medium-sized companies experienced a 58 percent increase in the number of claims during the 1970-1975 period while small companies had a 350 percent increase.
- the total number of claims that were litigated increased uniformly in the industry by 375 percent during the 1970-1975 period.
- there appears to be no trend in court judgments against the manufacturers.

the average cost of product liability coverage increased by 185 percent from 1970 to 1975. The median increase was 113 percent. Several companies, primarily small firms, reported an additional average increase in premiums of 198 percent from 1975 to 1976. One company reported a tenfold increase from $8,000 to $80,000.

INDUSTRIAL HEATING EQUIPMENT ASSOCIATION

Industrial Heating Equipment Association
1901 North Moore Street
Arlington, Virginia 22209

This association represents the major segments of the industrial heat processing equipment industry. They design and manufacture equipment that employs heat to produce or modify the materials and components incorporated into finished products.

The major points of the survey are:

- 53 responses covering the period 1971-1975.
- insurance costs more than doubled with smaller firms experiencing larger increases.
- small increase in the average size and the number of firms reporting deductibles.
- almost half of the companies experienced a product liability claim or suit.
- the number of new claims has doubled but the amout of damages sought has increased over 9,000%.
- the amount of damages sought in pending claims and/or suits has increased more than 2,000%.
- the number of pending claims/suits has also increased substantially - 1,000%.

NATIONAL MACHINE TOOL BUILDERS ASSOCIATION

National Machine Tool Builders Association
790 Westpark Drive
McLean, Virginia 22101

- 60 responses representing small, medium and large companies covering the period 1970-1976 (partial).
- average cost was less than 1% of sales for 1976.
- small and medium sized firms had rates below the largest firms.

- there were 704 claims between 1970 and 1975 or almost 12 for every company.
- 145 claims were settled out of court with an average settlement of $18,000 per claim.
- 58 suits of which the plaintiff won 16 or 2.7%.
- average amount of court judgment was $256,000.

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WOODWORKING MACHINERY MANUFACTURERS OF AMERICA

Most of the 46 companies which responded to the survey are engaged in manufacturing capital goods.

- most firms were small to medium in size.
- average primary insurance cost rose about tenfold between 1971 and 1976. As a percentage of sales, insurance was less than 1% in 1976.
- average limits and deductibles increased through the period. The average deductible was only $2,030 per firm.
- the number of claims and amount of damages sought increased substantially.

Survey reported in Interagency Task Force - Final Report.

WOODWORKING MACHINERY DISTRIBUTORS ASSOCIATION

- 32 responses covering the period 1971-1976.
- average cost of general liability increased fourfold.
- deductibles were reported by 7 firms in 1976 with an average deductible of $3,336.
- 9 claims were paid amounting to $194,650 for an average of $21,628 per claim.
- there are also 9 pending claims for 1976 seeking damages of over $2 million or an average of $226,111 per claim.

Survey reported in Interagency Task Force - Final Report.

AMERICAN TEXTILE MACHINERY ASSOCIATION

This survey consisted of 44 companies with the majority of them having sales under $5 million. They reported insurance cost increases of 936% between 1974 and 1976. However the cost still constituted less than 1% of sales. A breakdown of the data shows that the smaller firms have greater insurance costs relative to the larger firms. Also the percentage increase for the smaller companies was much higher. The number of pending claims and the amount of damages sought in pending cases have increased substantially from 1974 to 1975 (33% and 156% respectively). There also was a very substantial increase in dollars paid on claims settled out of court, 748%.

Survey reported in Interagency Task Force - Final Report.

RAILWAY PROGRESS INSTUTITE

Member firms produce virtually all equipment used by America's railroads including locomotives, freight cars, control and accessing devices, signal equipment and stampings.

- 13 firms responded which represents about 30% of the industry's sales covering the period 1970-1975.
- cost for product liability insurance was 0.09% of sales in 1975 which represented an 84% increase since 1970.
- limits of liability as well as the average size of deductibles increased.
- new claims and pending claims/suits have increased through the period.
- substantial increases in damages sought have also occurred.

Survey reported in Interagency Task Force - Final Report

AMERICAN DIE CASTING INSTITUTE

The 52 respondents were engaged in either producing metal castings or were affiliate members dealing in related products. Most of the firms were small or medium in size.

- primary product liability costs almost doubled during the period 1971 to 1975. The increases were largest in 1974 and 1975.
- five firms reported a deductible in 1975 but none prior to that year.
- several firms indicated claims and/or suits but information was not supplied.

Survey reported in Interagency Task Force - Final Report.

THE AUTOMOTIVE PARTS AND ACCESSORIES ASSOCIATION, INC.

The Automotive Parts and Accessories Association, Inc.
1730 K Street, N.W.
Washington, D.C. 20006

The respondents, 105 manufacturers and 14 distributor/retailers, are engaged in the manufacture, distribution and sales of automotive after market products.

- over the period 1971-1975 insurance costs rose about 340% with a range of 10% to 1,000%.
- 73 of 105 firms reporting indicating that claims typically arose from purchasers of products. All distributors indicated this was the case.
- 28 of 105 firms indicated the claim was typically a third-party action, while only four cited a Worker Compensation claim as being typical.
- about 50 percent of the firms indicated an increase in both the number and size of claims over the last five years. About 22 percent indicated a claims decrease. Somewhat less than 30 percent stated that the number and size of claims had remained the same.

AMERICAN TEXTILE MANUFACTURERS INSTITUTE, INC.

American Textile Manufacturers Institute, Inc.
1150 Seventeenth Street, N.W.
Washington, D.C. 20036

The survey was conducted during the summer of 1976 and completed in November, of that year. 148 responses were collected from firms which manufacture industrial fabrics, apparel fabrics, home furnishings, carpeting and hosiery. The 148 firms represent an even crossection of sizes.

- between 1971 and 1975 the average premium doubled. A breakdown by size shows that small firms experienced slightly higher increases.
- small firms have increased their limits of liability.
- deductibles have increased especially for the larger firms.
- 42 firms reported at least one claim since 1970 A large number of claims are pending.
- for 1975, 83 claims are pending with damages of over $93 million sought (average of over $1 million).
- 12 large firms had 149 law suits with average judgments of those suits lost to be about $20,000. The average out of court settlement was about $10,000.
- for 21 firms responding, the average amount of damages sought per claim in new claims filed has been highly variable: $636,000 in 1971, $874,000 in 1973, $588,000 in 1975 and $725,000 in 1976. No trends are apparent from this limited sample. Since the average amount of damages sought in claims and suits pending in 1975 was in excess of $1 million per claim, but the average amount per new claim filed during the 1971-1975 period was substantially less than $1 million, it appears that many of the large claims filed since 1970 have not been settled.

Attachment C

Model Methodology

Following is a description of the principles used in constructing the several models developed for the purpose of examining the tax deduction proposal.

Para. A

The exhibits were taken from actual quotations given to firms requesting coverage through an actual Market Assistance Plan of one of the states.

Para. B

The purpose of this paragraph is to modify the average claim cost taken from the Products Liability Closed Claim Study to provide for the cost of handling such claims. The Products Liability average claim cost for the applicable class of business taken from the Closed Claim Study was increased by the Insurance Services Office's standard factors for allocated loss expense and unallocated loss expense to provide for the cost of handling a typical average claim.

Para. C.

The purpose of this paragraph is to develop the number of claims which can be expected if losses occur consistent with the provision for loss in the insurance premium and the modified average claim cost developed in Paragraph B. The technique used is to apply the factor representing the proportion of premium which is for loss and loss expense (.571) to the premium which was quoted. This total loss expectation is then compared with the modified average claim cost developed in Paragraph B to obtain the expected number of claims. For example, in the case of the mechanical power press manufacturer the proportion of the B.I. premium which is for loss and loss expense is 117,169. With a modified average claim cost expectation of 102,590, the expected number of claims becomes 1.14. Similarly, for property damage the expected number of claims is .33, or one claim every three years.

Para. D

Displays the "normal" or average costs which can be expected for one year's operation, based upon the normal loss expectations - plus a provision for administrating a self-insurance program.

Para. E

Development of the relationship between the selected policy limit and the B.I. average cost. This provides the number of claims of average size that would be contained in the policy limit.

Model Methodology

Para. F

Using the information developed in the previous sections, this section demonstrates the cost to the business enterprise given a varying number of average claims and the relationship of these costs to sales for the business. In addition, this section identifies the costs that would be chargeable against a fund established in accordance with the federal proposal, and the excess of such chargeable costs over and above such fund. For purposes of illustration, it has been presumed that the business enterprise would pay into the fund an amount equivalent to the insurance premium it would have paid subject to the maximum fund of 3% of sales.

Para. G

The purpose of this paragraph is to demonstrate the impact if the business enterprise were to pursue the more conservative course of only self-insuring for the first 25,000 of each claim, rather than the full exposure for all products losses. The data displayed then represents a combination of insurance premiums and self-insurance costs computed on this basis but otherwise using the same principles as described for Paragraph F above.

Example 1

A. Risk General Characteristics

Product Type	:	Manuf. Mechanical Power Presses
Sales	:	2,700,000
Limit of Liab. Purchased	:	500,000 Single Limit
Rate	:	80.95
Premium	:	218,565
Maximum Fund of 3% of Sales:		81,000

B. Average Claim Cost

	Closed Claim Study Average	x	Provisions for: Alloc.	x	Unallocated		
BI	$69,718	x	1.35	x	1.09	=	$102,590
PD	14,345	x	1.48	x	1.09	=	23,142

C. No. of Claims Expectation

	Sales (000)	x	Rate	x	Prov.for Loss & Loss Exp.	=	Total Loss Expectation	÷	Average Claim Cost	=	No. of Claims
BI	2,700	x	76.00	x	.571	=	117,169	÷	102,590	=	1.14
PD	2,700	x	4.95	x	.571	=	7,631	÷	23,142	=	.33

D. "Normal" Annual Costs

B.I. Loss Expectation (From C)	=	117,169
P.D. Loss Expectation (From C)	=	7,631
Administrative Expense (25% x Prem.)	=	54,641
Total		179,441

E. Number of Claims Anticipated in Insurance Liability Limit

For B.I. only - 500,000 ÷ 69,718 = 7 Claims

Example 1
(Cont'd)

F. Costs Based on Various No. of Claims of "Expected" Average

B.I. Only

No. of Claims	Total Risk Costs		Costs Chargeable Against Fund	Excess of Costs Over Fund	
	Amount	% of Sales		Amount	% of Sales
0	54,641	2.0	0	(81,000)**	-
1	157,231	5.8	102,590	21,590	0.8
2	259,821	9.6	205,180	124,180	4.6
3	362,411	13.4	307,770	226,770	8.4
4	465,001	17.2	410,360	329,360	12.2
5	567,591	21.0	512,950	431,590	16.0
6	670,181	24.8	615,540	534,540	19.8
7	772,771	28.6	718,130	637,130	23.6
8	816,617*	30.3	762,976	739,720	27.4

* Limit of Liability + Full Allocated + Full Unallocated + Administrative Expenses
** 3% maximum fund.

G. Costs Based on 25,000 Deductible

Premium = (80.95 - 10.28*) x 2,700 = 190,809

Fund for Losses = 218,565 - 190,809 = 27,756

No. of Claims	Total Risk Costs		Costs Chargeable Against Fund	Excess of Costs Over Fund	
	Amount	% of Sales		Amount	% of Sales
0	190,809	7.1	0	(27,756)	-
1	215,809	8.0	25,000	(2,756)	-
2	240,809	8.9	50,000	22,244	0.8
3	265,809	9.8	75,000	47,244	1.7
4	290,809	10.8	100,000	72,244	2.7
5	315,809	11.7	125,000	97,244	3.6
6	340,809	12.6	150,000	122,244	4.5
7	365,809	13.5	175,000	147,244	5.5
8	390,809	14.5	200,000	172,244	6.4

* This represents the provision for loss in the first $25,000 of insurance

Example 2

A. Risk General Characteristics

Product Type	:	Hand Tools, Not Powered
Sales	:	11,000,000
Limit of Liab. Purchased	:	300,000 Single Limit
Rate	:	5.29
Premium	:	58,190
Maximum Fund of 3% of Sales	:	330,000

B. Average Claim Cost

	Closed Claim Study Average	x	Provisions for: Alloc.	x	Unallocated		
BI	32,579	x	1.35	x	1.09	=	47,940
PD	271	x	1.48	x	1.09	=	437

C. No. of Claims Expectation

	Sales (000)	x	Rate	x	Prov. for Loss & Loss Exp.	=	Total Loss Expectation	÷	Average Claim Cost	=	No. of Claims
BI	11,000	x	4.68	x	.571	=	29,395	÷	47,940	=	.61
PD	11,000	x	.61	x	.571	=	3,831	÷	437*	=	8.77*

* Closed Claim Study probably not representative

D. "Normal" Annual Costs

B.I. Loss Expectation (From C)	=	29,395
P.D. Loss Expectation (From C)	=	3,831
Administration Expense (25% of Prem.)	=	14,545
Total		47,771

E. Number of Claims Anticipated in Insurance Liability Limit

For B.I. Only - 300,000 ÷ 32,579 = 9.2

Exhibit 2
(Cont'd)

F. Costs Based on Various No. of Claims of "Expected" Average

B.I. Only

No. of Claims	Total Risk Costs		Costs Chargeable Against Fund	Excess of Costs Over Fund	
	Amount	% of Sales		Amount	% of Sales
0	14,548	0.1	0	(58,190)	-
1	62,488	0.6	47,940	(10,250)	-
2	110,428	1.0	95,880	37,690	0.3
3	158,368	1.4	143,820	85,630	0.8
4	206,308	1.9	191,760	133,570	1.2
5	254,248	2.3	239,700	181,510	1.7
6	302,188	2.7	287,640	228,450	2.1
7	350,128	3.2	335,580	277,390	2.5
8	398,068	3.6	383,520	325,330	3.0
9	446,008	4.1	431,460	373,270	3.4
10	468,158*	4.3	453,610	395,420	3.6

* Limit of Liability + Full Allocated + Full Unallocated + Administrative Expenses

G. Costs Based on 25,000 Deductible

Premium = (5.29 - .88) x 11,000 = 48,510

Fund for Losses = 58,910 - 48,510 = 10,400

No. of Claims	Total Risk Costs		Costs Chargeable Against Fund	Excess of Costs Over Fund	
	Amount	% of Sales		Amount	% of Sales
0	48,510	0.4	0	(10,400)	-
1	73,510	0.7	25,000	14,600	0.1
2	98,510	0.9	50,000	39,600	0.4
3	123,510	1.1	75,000	64,600	0.6
4	148,510	1.4	100,000	89,600	0.8
5	173,510	1.6	125,000	114,600	1.0
6	198,510	1.8	150,000	139,600	1.3
7	223,510	2.0	175,000	164,600	1.5
8	248,510	2.3	200,000	189,600	1.7
9	273,510	2.5	225,000	214,600	2.0
10	298,510	2.7	250,000	239,600	2.2

Example 3

A. Risk General Characteristics

Product Type	: Ski Equipment Mfg.
Sales	: 2,300,000
Limit of Liab. Purchased	: 500,000 Single Limit
Rate	: 10.50
Premium	: 24,150
Maximum Fund of 3% of Sales	: 69,000

B. Average Claim Cost

	Closed Claim Study Average	x	Provisions for: Alloc.	x	Unallocated	
BI	54,307	x	1.35	x	1.09	= 79,913
PD	18,275	x	1.48	x	1.09	= 29,481

C. No. of Claims Expectation

	Sales (000)	x Rate	x Prov. for Loss & Loss Exp.	=	Total Loss Expectation	÷	Average Claim Cost	=	No. of Claims
B.I.	2,300	x 10.00 x	.571	=	13,133	÷	79,913	=	.16
P.D.	2,300	x .50 x	.571	=	657	÷	29,481*	=	.02*

* Closed Claim Study average may not be representative

D. "Normal" Annual Costs

BI Loss Expectation (From C)	=	13,133
PD Loss Expectation (From C)	=	657
Administrative Expense (25% of Prem.)	=	6,038
Total		19,828

E. Number of Claims Anticipated in Insurance Liability Limit

For B.I. Only - 500,000 ÷ 54,307 = 9.2

Example 3
(Cont'd)

F. Costs Based on Various No. of Claims of 'Expected' Average

BI Only

No. of Claims	Total Risk Costs		Costs Chargeable Against Fund	Excess of Costs Over Fund	
	Amount	% of Sales		Amount	% of Sales
0	6,038	0.3	0	(24,150)	-
1	85,951	3.7	79,913	55,763	2.4
2	165,864	7.2	159,826	135,676	5.9
3	245,777	10.7	239,739	215,589	9.4
4	325,690	14.2	319,652	295,502	12.8
5	405,603	17.6	399,565	375,415	16.3
6	485,516	21.1	479,478	455,328	19.8
7	565,429	24.6	559,391	535,241	23.3
8	645,342	28.1	639,304	615,154	26.7
9	725,255	31.5	719,217	695,067	30.2
10	762,098*	33.1	756,060	731,910	31.8

* Limit of Liability + Full Allocated + Full Unallocated + Administrative Expense

G. Costs Based on 25,000 Deductible

Premium = (10.50 - 1.32) x 2,300 = 21,114

Fund for Losses = 24,150 - 21,114 = 3,036

No. of Claims	Total Risk Costs		Costs Chargeable Against Fund	Excess of Costs Over Fund	
	Amount	% of Sales		Amount	% of Sales
0	21,114	0.9	0	(3,036)	-
1	46,114	2.0	25,000	21,964	1.0
2	71,114	3.1	50,000	46,964	2.0
3	96,114	4.2	75,000	71,964	3.1
4	121,114	5.3	100,000	96,964	4.2
5	146,114	6.4	125,000	121,964	5.3
6	171,114	7.4	150,000	146,964	6.4
7	196,114	8.3	175,000	171,964	7.5
8	221,114	9.6	200,000	196,964	8.6
9	246,114	10.7	225,000	221,964	9.7
10	271,114	11.3	250,000	246,964	10.7

Example 4

A. Risk General Characteristics

Product Type	:	Electronics Components Mfg.
Sales	:	1,325,000
Limit of Liab. Purchased	:	500,000 Single Limit
Rate	:	2.53
Premium	:	3,352
Maximum Fund of 3% of Sales	:	39,750

B. Average Claim Cost

	Closed Claim Study Average	x	Provisions for: Alloc.	x	Provisions for: Unallocated		
BI	523	x	1.35	x	1.09	=	770
PD	2,786	x	1.48	x	1.09	=	4,494

C. No. of Claims Expectation

	Sales (000)	x	Rate	x	Prov. for Loss & Loss Exp.	=	Total Loss Expectation	:	Average Claim Cost	=	No. of Claims
BI	1,325	x	.60	x	.571	=	454	:	770	=	.59
PD	1,325	x	1.93	x	.571	=	1,460	:	4,494	=	.32

D. "Normal" Annual Costs

BI Loss Expectation (From C)	=	454
PD Loss Expectation (From C)	=	1,460
Administrative Expense (25% of Prem.)	=	838
Total		6,852

E. Number of Claims Anticipated in Insurance Liability Limit

For BI Only - 500,000 : 523 = 956 claims
For PD Only - 500,000 : 2,786 = 179 claims
For BI & PD - 500,000 : 3,309 = 151 claims

Example 4
(Cont'd)

F. Costs Based on Various No. of Claims of "Expected" Average

PD Only

No. of Claims	Total Risk Costs		Costs Chargeable Against Fund	Excess of Costs Over Fund	
	Amount	% of Sales		Amount	% of Sales
0	838	0.06	0	(3,352)	-
1	5,332	0.40	4,494	1,142	0.08
2	9,826	0.74	8,988	5,636	0.42
3	14,320	1.08	13,482	10,130	0.76
4	18,814	1.42	17,976	14,624	1.10
5	23,308	1.76	22,470	19,118	1.44
6	27,802	2.10	26,964	23,612	1.78
7	32,296	2.43	31,458	28,106	2.12
8	36,790	2.77	35,952	32,600	2.46
9	41,284	3.11	40,446	37,094	2.80
10	45,778	3.45	44,940	41,588	3.14

G. Costs Based on 25,000 Deductible

Premium = (2.53 - .43) x 1,325 = 2,783

Fund for Losses = 3,352 - 2,783 = 569

No. of Claims	Total Risk Costs		Costs Chargeable Against Fund **	Excess of Costs over Fund	
	Amount*	% of Sales		Amount	% of Sales
0	2,783	0.21	0	0	0
1	5,569	0.42	2,786	2,217	0.20
2	8,355	0.63	5,572	5,003	0.40
3	11,141	0.84	8,358	7,789	0.60
4	13,927	1.05	11,144	10,575	0.80
5	16,713	1.26	13,930	13,361	1.00
6	19,499	1.47	16,716	16,147	1.21
7	22,285	1.68	19,502	18,933	1.43
8	25,071	1.89	22,288	21,719	1.64
9	27,857	2.10	25,074	24,505	1.85
10	30,643	2.31	27,860	27,291	2.06

*Insurance premium ($2,783) plus average loss ($2,786) x number of claims - In this column we used average loss instead of deductible amount because the average loss ($2,786) was less than the deductible ($25,000).

** average loss ($2,786) x numb[illegible] of claims - same amount as above.

ATTACHMENT D

SHEA GOULD CLIMENKO & CASEY
330 MADISON AVENUE
NEW YORK, NEW YORK 10017

EUROPEAN OFFICE

August 17, 1978

American Insurance Association
1025 Connecticut Avenue, N.W.
Washington, D.C. 20035

Attention: Walter D. Vinyard, Jr.
Senior Counsel

Re: Product Liability Self-Insurance - H.R. 12429

Dear Sirs:

In accordance with your request, we have reviewed several recent legislative proposals which provide certain tax incentives for the establishment of programs of self-insurance for product liability losses. One such proposal is H.R. 12429 (the "Bill") which seeks to amend the Internal Revenue Code of 1954 (the "Code") to allow a deduction to a specified class of taxpayers for certain amounts contributed to product liability loss reserve accounts established by the taxpayer. In addition to the numerous technical problems found in the Bill, we believe there are fundamental tax and public policy considerations which militate against enactment of such legislation.

Summary of H.R. 12429

The Bill provides that electing taxpayers who establish a special "Product Liability Loss Reserve Account" for the exclusive purpose of satisfying product liability losses and related expenses of settling claims for compensation are allowed a deduction for amounts transferred to such account. A deduction is also allowed for amounts paid to a captive insurer for product liability insurance. Taxpayers engaged in a trade or business involving the manufacture, importation, distribution or sale of a product with respect to which the taxpayer may incur product liability losses are eligible for the election.

The amount which may be deducted in a single taxable year is limited to the amount fixed by a formula contained in the Bill which depends in part upon whether the taxpayer qualifies as having a "severe product liability insurance problem." In either event, the limit is fixed by the lower of:

(a) a fixed percentage of gross receipts derived by the taxpayer from the product for the taxable year;

(b) an amount which when added to the account equals a fixed percent of the taxpayer's average yearly gross receipts derived from the product; or

35-992 O - 79 - 14

(c) a flat dollar amount ($100,000 per year in the case of a severe product liability insurance problem or $25,000 for the other taxpayers).

Thus, the taxpayer's actual experience is not the determining factor in computing the allowable deduction, and there is no requirement that any minimum annual contribution be made or minimum total reserve be maintained.

The "Product Liability Loss Account" is defined to mean a segregated trust fund with an independent trustee, the assets of which may only be invested in Federal, state or local debt securities, time or demand deposits or an insured credit union. Amounts disbursed by the fund to pay for product liability losses are specifically excluded from the taxpayer's income under Section 61, and deductible transfers to the fund are not subject to the accumulated earnings tax imposed by Section 531 of the Code. The Bill would also grant the taxpayer an election to either retain the income earned by the assets in the reserve account or to transfer it to the account. In addition, the Secretary is directed to prescribe regulations concerning the manner in which the taxpayer may terminate the fund and have the funds therein distributed to the taxpayer without penalty.

Discussion

H.R. 12429 would use the Code to redress non-tax problems and illustrates the inequity and difficulties of doing so. Any addition to the Code for such a purpose must be justified from both a tax and a public policy viewpoint. We believe the substance of H.R. 12429 fails both tests: it is unworkable and conceptually unsound from the tax viewpoint, and it falls far short of achieving its apparent public policy objectives.

A deduction for contributions to a self-insurance reserve is simply not an effective means of making funds available to the parties affected by a product liability loss. It may, instead, provide tax benefits to taxpayers who suffer no losses, and be of no assistance to others at the time of a loss.

Violation of Principles of Tax Law and Accounting

The reserve deduction mechanism under the Bill is defective for tax purposes because it violates sound principles of tax law and accounting: that is, the deduction fails to reflect the incurrence of a fixed or known liability. The

general and long-established rules governing deductibility by a taxpayer utilizing the accrual method of accounting are that "all events" must have occurred which establish the fact of the liability giving rise to the claimed deduction, and the amount of the deduction can be determined with reasonable accuracy. Generally accepted principles of accounting, consistently used, must also be observed. See Regulations § 1.446-1(c)(1)(ii) and § 1.461-1(a)(2).

Accordingly, under existing law, taxpayers generally are not allowed deductions for additions to reserves for self-insurance. Revenue Ruling 60-275, 1960-2 C.B. 43, 45, states the rule as follows:

> "Following a long-standing rule which denies deductions for all reserves except those specifically authorized by statute (Arthur M. Brown v. Helvering, 291 U.S. 193, Ct. D 786, C.B. XIII-1, 223 (1934)), both the Service and the courts have long held that amounts set aside by a taxpayer as a reserve for self-insurance, though equal to commercial insurance premiums, are not deductible for Federal income tax purposes as an expense 'paid or incurred.' See Rev. Rul. 57-485, C.B. 1957-2, 117, and Pan American Hide Company v. Commissioner, 1 B.T.A. 1249. The fact that the fund is administered by an independent agent does not make contributions to such a fund deductible. See Spring Canyon Coal Company v. Commissioner, 43 Fed. 2d 78, Ct. D. 237, C.B. IX-2, 379 (1930), certiorari denied, 284 U.S. 654, Moreover, an element of risk-shifting or risk-distributing is one of the requisites of a true

insurance contract. See Guy T. Helvering v. Edythe LeGierse, 312 U.S. 531, Ct.D 1491, C.B. 1941-1, 430.

Additions to a product liability self-insurance reserve would clearly be non-deductible under these well-established principles. Contributions to the fund would not constitute irrevocable payments in discharge of a known liability, and there is obviously no risk-shifting in the case of a single taxpayer establishing a fund to discharge contingent liabilities of the same taxpayer.

Thus, the fact that the reserves are actually contributed to a separate reserve fund administered by an independent agent, and do not represent mere bookkeeping entries for financial accounting purposes, does not make contributions to such a fund deductible. In Spring Canyon Coal Co. v. Comm'r., 43 F.2d 78 (10th Cir. 1930), cert. denied, 284 U.S. 654 (1931), cited in Revenue Ruling 60-275, supra, the taxpayer was denied a deduction for contributions to such a reserve fund maintained as a form of self-insurance against workmen's compensation claims. The Court noted that the taxpayer had the benefit of accruals to the fund, in that such accruals were available to pay its legal obligations, and distinguished them from payments for premiums which constitute actual expenses. This critical distinction was explained by the Court, as follows:

"The whole object of self-insurance is to avoid the expense of insurance premiums. If the petitioner had elected to insure its risks in the state fund or a private company, it would have expended the premium and shifted the risk; instead, it retained the risk and kept the premium. Having elected not to expend the premium, it cannot charge a corresponding sum as an 'expense.' The 'expenses' incurred and deductible were the sums paid its injured workmen, and not the amounts set aside for their protection; the petitioner is not entitled to deduct as an expense a sum of money which it might have expended for insurance premiums, but did not." 43 F.2d 80.

More recently, the courts have rejected arguments that reserve deductions are necessary to accurately reflect income for tax purposes, where no payment has been made on account of any loss and the fact and amount of any future liability is not known in the year of the addition to a reserve. Thus, in 1973, in Thriftimart, Inc. v. Comm'r, 59 T.C. 598, the Court held that a taxpayer was not entitled to deduct accruals to its reserves for workmen's compensation self-insurance because of the contingent nature of the liabilities.

Furthermore, in 1977, the principles established in Spring Canyon have been applied by the Service to deny deductions for casualty insurance "premiums" paid by a corporate

taxpayer to a wholly-owned insurance subsidiary. Rev. Rul. 77-316, 1977-35 I.R.B. 7. The Service ruled that to the extent the risk of loss was not fully maintained by an unrelated insurance company, there is no risk-shifting or risk-distributing, and no insurance. In addition, because the amounts paid remained under the practical control of the taxpayer, the Service ruled that there were no amounts "paid or incurred" which were deductible. See also Rev. Rul. 60-275, supra.

Allowing a deduction for additions to the Product Liability Loss Reserve Account contemplated by the Bill would violate these well-established principles concerning proper tax accounting treatment of self-insurance reserves. As noted by the Court in Thriftimart, supra, self-insurance reserve accounts amount to nothing more than a reserve for contingent liabilities. Thus, in disallowing deductions on account of the taxpayer's reserve for workmen's compensation self-insurance, the Court in Thriftimart rejected the taxpayer's argument that such deductions were essential to accurately reflect its net income.

Special Nature of Insurance Company Reserves

The Code provides special tax treatment for an "insurance company" which makes inapplicable to them the "all

events" test applicab͏le generally to accrual-method taxpayers, by providing special rules of tax accounting which effectively constitute an exception to this test. Sections 818(a) and 832(b)(1)(A) and (b)(6) of the Code. Such a departure has been deemed appropriate by Congress because there exist exhaustive and detailed accounting principles long established and approved by the National Association of Insurance Commissioners ("NAIC") which are reflected in NAIC "Annual Statements" prepared by insurance companies and filed with Federal and state authorities. Continental Insurance Company v. United States, 474 F.2d 661, 666-67 (Ct. Cl. 1973); and Bituminous Casualty Corporation v. Comm'r, 57 T.C. 58, 78-80 (1971).

Congressional sanction in the Code of the use of the Annual Statement form of accounting approved by the NAIC properly reflects a number of important facts unique to insurance companies, and is intended to avoid distortion of income on an annual basis which would otherwise arise from the application of principles ordinarily associated with the "all events" test.

More specifically, life insurance companies undertake contractual obligations which extend over three or more

generations of time. Their business necessarily involves calculations of premiums to be received, income to be earned, expenses to be paid and claims and obligations to be discharged over an extended period of time. Such calculations are essential to the insurance feature, the basic function of which is risk-sharing. Since it is an industry which operates in the public interest, Federal and state legislators and regulators establish standards which must be met in order that their long-term insurance obligations be funded on a sound basis and discharged on a timely basis.

In a similar vein, property-casualty insurers must, under Section 832 of the Code, calculate losses "which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay." Regulations § 1.832-4(b). These reserves include both those established for the cost of known claims and those intended to cover incurred but not reported claims. Not all of the events have occurred which would permit a deduction of these amounts under the accrual method of accounting. However, the initial event (the occurrence) has taken place and the estimated dollar amount, in the aggregate, can be determined within

reasonable standards of accuracy. In addition, property and casualty companies are permitted to deduct certain expenses (cf. Sections 831 and 832 of the Code) which, under generally accepted accounting principles, would be capitalized.

It is against this backdrop of policyholder obligations, the importance of the insurance function involved, extensive state governmental regulation and sound funding considerations that special provisions of the Code provide insurance companies with a current deduction for amounts set aside as required reserves and for losses and expenses in accordance with NAIC-approved Annual Statement forms. A more detailed discussion of certain of these special provisions is set forth below, at pages 21-25.

Potential Tax Distortion Under H.R. 12429

Allowing deductions to taxpayers generally for amounts transferred from general taxpayer assets to a reserve for future contingencies, as would be permitted by the Bill, would enable such taxpayers to distort their taxable income for the year. While the Bill would set a yearly limitation on the amount of the deduction, it is not based on actual

liabilities incurred during the taxable year, nor is it otherwise tied to the actual experience of the particular taxpayer aside from the special limitation on additions contributed by taxpayers with a "severe product liability insurance problem." The potential for abuse is evident. The taxpayer may have more than adequate surplus and reserves for any future liabilities, yet could choose to add to those reserves in any taxable year solely to reduce its taxable income. The reverse situation could also arise where the reserve fund may be wholly inadequate to cover the taxpayer's actual or potential liability, and thus it would afford little comfort to the taxpayer suffering the loss. This lack of correlation between the deduction and the existence of the offsetting liability is precisely the reason that the reserve additions are not generally deductible under established tax accounting methods. Moreover, product liability losses are extremely unpredictable, so that the reserve mechanism without any risk-shifting is particularly unsuited to this type of liability as a means of making funds available to cover specific losses.

The Bill would treat all payments made to the reserve accounts as amounts "accumulated for the reasonably anticipated needs of the business" for purposes of the accumulated earnings

tax imposed by Section 531 of the Code, thus removing a statutory safeguard against abuses which would otherwise be applicable to protect the government revenue, subject to the taxpayer's establishing through evidence of past experience that a reasonable need for self-insurance reserves exists. W.L. Mead, Inc. v. Comm'r, 34 T.C.M. 924 (1975), aff'd, 551 F.2d 121 (6th Cir. 1977).

It must be assumed, therefore, that the Bill recognizes the highly unpredictable nature of product liability losses; otherwise, there is no need for the exception from what could otherwise be an "unreasonable accumulation." To allow a current deduction for additions to reserves for contingent liabilities for which the taxpayer may not even be able to satisfy the burden of proof of "reasonable needs of the business" imposed by Section 534, is clearly an unwarranted and radical departure from existing principles of tax accounting. It is certainly not sound tax policy to allow a deduction for additions to a reserve account where the taxpayer's aggregate reserves may already exceed "the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business." Reg. § 1.537-1(a). The taxpayer thus retains the ability to reduce or avoid both income and accumulated earnings tax

liability by simply transferring funds to a segregated reserve fund.

Trust Fund Complications

The reserve trust fund mechanism raises other serious questions of administration, tax accounting and potential taxpayer abuse relating to income generated by the fund assets and withdrawals from the fund. Under the Bill, the taxpayer would be permitted to withdraw income earned and amounts previously transferred to the reserve account, and the taxpayer would even be able to terminate the reserve account and have accumulated reserves distributed to him without penalty.

If the reserve funds are invested in tax-exempt bonds, the taxpayer would enjoy the benefit of tax-free income generated from the investment of funds for which he received a current deduction at the time of transfer to the trust. Moreover, the use of such funds would become such an attractive vehicle for investing, that as the funds grow an entirely new market for tax-exempt funds would be created which could cause serious disruptions in the debt market.

The taxpayer also retains control over disposition of the assets of the trust. While it may be possible to fashion regulations which would curb somewhat the obvious potential for taxpayer abuse, it is evident that the basic tax structure proposed is fundamentally inconsistent with sound tax policy. To allow a taxpayer to enjoy the tax-free buildup of a reserve fund under its control, while retaining the right to the income of the fund, will surely result in a distortion of the taxpayer's income. The fund could become a tax shelter device free from any effective supervision.

The Bill leaves unanswered numerous other critically important questions concerning the nature of the trust fund and the fiduciary responsibilities. The amount of reserves involved will be large in the aggregate, yet unlike employee benefit plans maintained pursuant to the provisions of the Employee Retirement Income Security Act of 1974 ("ERISA"), no standards or guidelines are provided in the Bill with respect to funding requirements, fiduciaries, self-dealing or other prohibited transactions. The self-insurance reserve may also have serious liquidity problems, since there is no way to accurately estimate funds needed to meet

contingent liabilities. This may result in problems of fiduciary liability under general legal principles even if ERISA-type standards are not adopted.

In addition, there is no specified class of trust beneficiaries with defined interests which must be protected.

Significant legal issues with respect to disposition of the funds upon insolvency, bankruptcy, transfer of assets, merger, etc., of the contributing taxpayer are not addressed. If it is intended that the funds are not to be reached by creditors of the contributor, which is unclear, there may be state law problems concerning the legality of transfers to the reserve in fraud of creditors or transfers at a time when the taxpayer's surplus is low. Clearly, the complexity of the underlying legal problems relating to the establishment and operation of such funds requires more extensive consideration and regulation and an effective means of policing participation.

No Precedent For The Bill Under Existing Code Sections Dealing With Reserve Deductions

Deductions for additions to certain types of reserves

which are currently authorized by the Code are fundamentally different from the proposed self-insurance reserve. One such provision is Section 166(c) which allows under certain circumstances a deduction for reasonable additions to a reserve for bad debts. In Revenue Ruling 58-305, 1958-1 C.B. 117-8, the Service distinguished such reserves from those for contingent liabilities as follows:

> "Section 166(c) of the Code authorizes the deduction of reasonable additions to a reserve for bad debts. The reserve contemplated under such section, however, relates only to amounts set aside from the gross income of a business to provide for probable losses _with respect to accounts and notes receivable on which credit has been extended_.
>
> The general proposition that amounts credited to a reserve to cover contingent liabilities may not be deducted for Federal income tax purposes until such liabilities become fixed is well settled. _Lucas_ v. _American Code Co., Inc._, 280 U.S. 445, Ct.D 168, C.B. IX-1 314 (1930); _Arthur M. Brown_ v. _Helvering_, 291 U.S. 193, Ct.D 786, C.B. XIII-1, 223 (1934); _Lane Construction Corporation_ v. _Commissioner_, 17 B.T.A. 825. (Emphasis supplied.)

The bad-debt reserve deduction is thus allowed with respect to amounts already paid out by the taxpayer which the taxpayer's experience shows will not be returned. It is a tax accounting adjustment which is made to properly reflect

income, and it thus conforms to proper tax accounting methods. Moreover, the taxpayer bears the burden of showing that the annual addition is reasonable in view of the total reserves on hand at the end of the taxable year to cover expected bad debts. Reg. §1.166-4. This is to be contrasted with deductions for additions to a fund over which the taxpayer retains control, the assets of which are used to pay future contingent losses, particularly where no showing need be made that the reserves are reasonable.

Section 585 of the Code provides special rules for bad-debt reserves for electing commercial banks. Prior to enactment of that Section as part of the Tax Reform Act of 1969, commercial banks had been permitted by administrative rulings more generous bad-debt reserves than most taxpayers. However, the problem of unreasonable accumulations was recognized by the Service, as for example in Mimeograph 6209, 1947-2, C.B. 26 which stated:

> "However, such reserve cannot be permitted to accumulate indefinitely simply because of the possibility that at some future date large losses may be concentrated within a relatively short period of time and operate to absorb the greatest probable reserve. To permit this would sanction the deduction

35-992 O - 79 - 15

> of a mere contingency reserve for losses, which is not an allowable deduction for income or excess profits tax purposes. This latter rule makes imperative the imposition of some reasonable ceiling on the accumulation of the reserve other than such indefinite limitation as might eventually prevail under a moving average method."

In order to bring the bad-debt reserves allowed for banks under the rulings into line with the bad-debt reserves allowed for other taxpayers generally,[1/] Section 585 was enacted. That Section provides that after 1987, banks will generally be permitted to add to their bad-debt reserves only the amount determined on the basis on the "experience method" set forth therein. Under this method, the banks are generally required to justify reserves on the basis of actual experience over a six-year period.

As is evident from the foregoing, the reserve deductions proposed by the Bill are entirely different in purpose and operation from the bad-debt reserve deductions available to commercial banks. In limiting the additions to the bad-debt reserve to an amount based on the recent experience of the bank, Congress recognized that this reserve mechanism was not intended to create

1/ See, H. Rep. No. 91-413, Part 1, 91st Cong., 1st Sess. 121 (1969).

a fund for unexpectedly large future losses such as are contemplated in the case of reserves for product liability losses. Congress provided for a different means of providing relief in the case of such a loss, by enacting the special net operating loss carryback rules of Section 172(b)(1)(F). The Ways and Means Committee provided the following explanation for the addition of that Section:2/

> "As a general rule, the bad-debt reserves that banks are permitted to build up under the bill will be adequate to cover losses. However, to provide an extra margin of safety to protect against the possibility of unusually large bad-debt losses, banks will be permitted to carry back net operating losses for 10 years instead of 3 years as under present law. In addition, commercial banks will be permitted, as under present law, to carry forward net operating losses for 5 years."

A net operating loss carryback is obviously a more effective means of making funds available to cover a particular loss incurred without extending any tax benefits to taxpayers not incurring such a loss.

In addition to the more restrictive limitations on additions to bad-debt reserves imposed by Section 585, Congress

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2/ Id.

enacted a separate safeguard against possible abuses of the reserve method by financial institutions during the transitional period of Section 585. Thus, as part of the Tax Reform Act of 1969, Section 57 of the Code was amended to include as an item of tax preference the amount by which the reasonable addition to reserves for bad debts of a financial institution exceeds the amount which would have been allowable based on the actual experience of the institution. However, since under H.R. 12429 the reserve addition allowed to the taxpayer is not premised upon the actual experience of the taxpayer, the tax preference mechanism does not offer a sensible means of safeguarding against potential abuses of the self-insurance reserve.

The Code also contains special provisions allowing deductions for additions to reserves in the case of insurance companies. However, such deductions are actuarially determined, subject to state supervision by state insurance authorities and the earnings thereon are subject to insurance company tax rates. As in the case of the other special Code provisions dealing with reserves discussed above, they provide no logical basis of support or favorable comparison for the self-insurance reserve proposed in the Bill.

Life insurance companies, which are taxed under special provisions of the Code enacted as the Life Insurance Tax Act of 1959, generally may deduct amounts set aside in policyholder reserves in computing their income which is subject to tax. However, two requirements attaching to their deductibility readily distinguish them from self-insurance reserves: the reserves must be required by law (with certain limited exceptions); and they must also be computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest. Section 801 of the Code. Self-insurers under the Bill would fail to meet both requirements.

In Revenue Ruling 67-435, 1967-2 C.B. 232, the Service explains the importance of each requirement for tax purposes. Noting that not all reserves maintained by a life insurance company are deductible, the Service quotes the following basic test established by the Supreme Court in McCoach v. Insurance Company of North America, 244 U.S. 585 (1917):

> "The Act of Congress, on the other hand, deals with reserves not particularly in their bearing upon the solvency of the company, but as they aid in determining what part of the gross income ought to be treated as net income for purposes of taxation."

The Ruling analyzes the nature and function of a life insurance reserve, as follows:

> "The life insurance reserve is in the nature of a trust and represents a policy liability of the company to its policyholders. On the basis of experience, it is known that a certain number of the outstanding policies will become claims at any one time and given the experience of the same age groups, the probabilities of death or disability can be fairly accurately predicted. Thus the life insurance reserve, broadly defined as the difference between the present value of the benefits and the present value of the future premiums is grounded upon assumptions as to the rate of death for every age of life and assumed rates of interest which the company may reasonably expect to be realized upon the investment of the excess premiums for the duration of the policies. The calculation of the reserve is an actuarial function and is the amount theoretically necessary to be 'reserved' out of premiums, which, at assumed rates of interest, will enable the company to pay all outstanding policies as they become claims, providing the facts are in accord with the assumptions made. Since only a certain number of the outstanding policies will become claims at any one time, the mortality tables and assumed rates of interest on which the life insurance reserve is based do not provide for every contingency. They do not provide for investment losses, changing expense ratios, or unfavorable mortality experience. If they did, they would produce an assumed rate of mortality far greater than necessary to cover the certain mortality costs."

The Ruling concludes that certain life insurance reserves

based on a formula which was unrelated to any recognized mortality or morbidity table, which were required by a state for solvency purposes, did not meet the test that the reserve be set aside to mature or liquidate future unaccrued claims as they mature, and thus did not constitute a life insurance reserve within the meaning of Section 801(b). Self-insurance reserves would, of course, fail any test of deductibility for the same reason-- the reserves are not based on a recognized actuarial, mortality, interest or any other experience factor.

In accordance with the foregoing, Section 824 of the Code allows mutual fire and casualty companies deductions for additions to a "protection against loss account." It is one of the special provisions of the Code taxing insurance companies issuing property and liability insurance which are organized and regulated under state law. Accordingly, it does not provide a valid analogy for the proposed self-insurance reserve. The amount deductible as an addition to the protection against loss account is based on a percentage of underwriting gains and losses incurred during the taxable year. The amounts added to the account are available to meet certain losses for five years, after which

most of any remaining portion will be included in taxable income of the sixth year. Thus, unlike the proposed self-insurance reserve, the deduction allowed represents only a deferral of tax for the five-year period and not a complete escape from tax on an unlimited buildup of reserves. Moreover, Section 824 also calls for an adjustment to the account to insure that there is no reduction of current tax on investment income, and Section 825 contains a special carryover and carryback provision in the case of extraordinary underwriting losses.

As is evident from the foregoing, the proposed deduction for additions to a product liability self-insurance reserve represents a radical departure from accepted principles of tax accounting, is inconsistent with other provisions of the Code dealing with reserves and creates a means of escaping tax on income which is never used to satisfy a liability. The lack of correlation between the tax deduction and any potential liability is objectionable and ineffective from the tax viewpoint. Any such reserve system would have to be closely regulated and tied closely to the taxpayer's experience. Otherwise, the tax benefits may be realized, and the financial liabilities incurred, by different taxpayers.

Public Policy Objectives Not Achieved

It is apparent that the proposed reserve is equally objectionable from a public policy viewpoint for the same reason. Unlike other Code provisions enacted to funnel resources into certain activities, there is no guaranty that the funds generating the tax benefit will be used to satisfy the losses intended to be covered. Thus there is a great tax cost without any corresponding benefit in furtherance of the public policy objectives. Such a system of self-insurance is clearly not cost effective. Moreover, since experience is not determinative in setting reserves and losses are difficult to predict, there is no assurance that the taxpayer is protected against large losses in any event.

Public policy must be equally concerned with the interests of the consumer -- the person suffering the losses. There is clearly no guaranty that the taxpayer liable for the product liability claims will have adequate reserves, since the limitations on reserve additions are not tied to the experience of the individual taxpayer or any broader-based experience factor. This problem is compounded by the fact that reserve payments are wholly voluntary from year to year.

Moreover, it cannot be said that the Product Liability Loss Reserve Account is dedicated to the exclusive purpose of satisfying product liability losses sustained by the taxpayer, since the taxpayer retains control over the income and ultimate disposition of the corpus of the trust. If bonds or tax-exempt obligations are purchased, their market value would decline as interest rates rise and the trust corpus available for loss payments would decline even though the taxpayer could claim the income. It is only the potential claimant who stands to suffer if the value of the trust corpus decreases. Without an irrevocable dedication of funds to the reserve, and proper regulations or other safeguard to assure proper management of the fund, the interests of the consumer would clearly not be protected and the fund could become simply a mechanism for tax avoidance by the taxpayer. The elaborate fiduciary rules of ERISA might well be required before long.

The system of self-insurance proposed by the Bill disregards the basic function of insurance. As discussed above, additions to a Product Liability Loss Reserve Account permitted by the Bill will not provide a meaningful substitute for insurance because the size of the fund is not related to

actual or even estimated future losses. The allowance is simply a tax incentive to create a fund. It is at best highly questionable that the creation of such unsupervised funds would be worth the loss of tax revenues, in view of the fact that such funds fail to reflect sound tax policy, have great tax avoidance potential, and are not an effective means of achieving public policy objectives. If such funds were used as a literal substitute for insurance the very protection against loss sought by the Bill would be seriously impaired.

In this regard, one final issue raised by the Bill which goes to the heart of the insurance function is the possibility of establishing pooled funds and the use of captive insurers. The Bill would provide an incentive to establish captive insurers which are licensed under state law, yet it would limit deductions under the same formula applicable to additions to Product Liability Loss Reserve Accounts. There is also the possibility that multiple taxpayers could establish and contribute to a single Product Liability Loss Reserve Account, which could thus in many states constitute a *de facto* insurance company subject to state regulation. In fact, it is possible accounts established by single taxpayers would be similarly

classified under state law. However, due to the funding limitations, there is no assurance that these de facto insurance companies would have adequate reserves.

The taxation of investment income of these insurers is also unclear. Presumably special Code provisions governing insurance companies generally should apply, although the Bill is silent on this point. If they did not, the captive insurer would have an unfair competitive advantage. An endless tax-free buildup of reserves is obviously not a tolerable alternative. Utilizing a deduction from Federal income taxes to create mini-insurance companies is clearly not a sensible solution to current problems associated with product liability losses.

Summary and Conclusions

H.R. 12429 raises a host of fundamental legal, equitable, tax policy, tax accounting, public policy, and overall business-sense questions.

It is apparently designed to aid and protect taxpayers which may incur product liability losses by providing a tax benefit to them. While the Bill, if enacted, would

unquestionably provide benefits to such taxpayers (even though some might suffer no losses), it provides no assurance that funds will be available to assist injured parties at the time of their loss.

From a general legal and tax viewpoint, the Bill violates long-established principles to the effect that deductions are allowable with respect to the incurrence of a fixed or known liability, and not merely for the purpose of allowing a taxpayer to establish reserves for self-insurance. It requires no great imagination to visualize how many different kinds of taxpayers would like to reduce taxes by creating such reserves.

Decisional law and Internal Revenue Service rulings of long standing must be conceptually rejected and overturned, if this Bill is to be enacted. Any departure from the accepted standards long applied to deductions for reserves must be closely scrutinized, and the case for such a departure must be clear and convincing on all important grounds.

A Bill such as this one, which would permit taxpayers to withdraw income earned on amounts contributed

to a reserve account, will undoubtedly lead to the investment of funds in tax-exempt securities and have a disruptive effect of serious proportions over a period of time in the tax-exempt markets. The adoption of H.R. 12429 concepts which, in effect, would create a tax shelter device of importance, free from effective supervision, seems unwise.

The Bill would sanction the development of large trust funds in the aggregate, which inherently involve fiduciary responsibilities. To deal with such responsibilities wisely and prudently would entail the inclusion in the Bill of standards and guidelines with respect to any type of self-dealing or other prohibited transactions, such as those enumerated in ERISA. Mechanisms for monitoring appropriate performance by those funds would have to be established in time, if not immediately. Identification of the classes of beneficiaries of the trust who are to be protected would be needed, and this would create greater complexities.

The Bill would also create unanswerable questions regarding creditors' rights generally under various state laws, in the event of insolvency, bankruptcy etc. The

complexity of the problems in this area requires far more consideration than has as yet been given to the matter, and indicates another area in which detailed regulations may be required.

Analysis of other sections of the Code relating to deductions for additions to certain types of reserves such as those maintained by commercial banks for bad-debt reserves have been reviewed and found to be intrinsically different in substance and effect from the proposed Bill. The proposed product liability reserve fund deductions are entirely different in purpose and operation from the bad-debt reserve deductions available to commercial banks. Furthermore, the Congress has previously recognized the abuse of tax reserves in this area, by including excess bad debt reserves as an item of preference. Similarly, deductions for reserves permitted to life insurance companies are based upon entirely different concepts which require that they be based upon recognized mortality or morbidity tables and assumed rates of interest, and be required by law. The proposed product loss reserve would lack these essential elements. Similarly, deductions allowable to mutual fire and casualty companies for additions to a loss account have

built-in protection devices and provide only limited tax deferral and not a complete escape from tax on an unlimited buildup of reserves.

It is our view that the problems created by this Bill far outweigh any potential benefits to be derived from its enactment. Substantial tax cost could result without any corresponding benefit to the public in furtherance of the Bill's public policy objectives. Overall, the legal, equitable, tax accounting and tax policy issues raised, which require extended analysis and consideration, are substantial and complex. In view of such problems and issues, the likelihood of achieving sound public policy objectives in a prudent, economic manner by enactment of the Bill is too remote to merit its favorable consideration.

Very truly yours,

Alexander Grant Dimarlio & Casey

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ANDREW F. BRIMMER
President

August 23, 1978

The Honorable Russell B. Long
Chairman, Committee on Finance
2227 Dirksen Office Building
United States Senate
Washington, D.C. 20510

Dear Senator Long:

I am writing in response to your notice of public hearings August 28, 1978, concerning S. 1611 and S. 3049. The first bill would provide tax deductions for additions to a reserve for product liability losses, and the second would provide tax deductions for amounts placed in a reserve for product liability losses and expenses and for amounts paid to captive insurers. I would like very much to testify, but I must be in Brazil on August 28, and cannot adjust my itinerary to appear during your hearing.

In response to a request by the American Insurance Association, BRIMMER & COMPANY completed a study August 15 on Tax Incentives and Self-Insurance Against Product Liability. The main purpose was to estimate the potential loss of revenue to the Federal Treasury that might result from adoption of tax incentives for self-insurance.

In our study (for which I had principal responsibility), five different propositions which have been introduced in Congress were assessed, and their potential impact on the U.S. Treasury was estimated. The analysis was based primarily on data for 856 large corporations (with sales in excess of $100 million) and for a random sample of 300 companies, a significant proportion of which represent industries which encounter product liability problems.

If these 856 large corporations were to take deductions allowed under any one of these propositions, the losses to the U.S. Treasury could range from $36 million to $12 billion, depending upon the specific alternative. If the average premium rate for all products (except those in the severe product category) is .34 per cent, a deduction allowed under legislation involving a 2 per cent or 5 per cent of sales would substantially increase the loss to the U.S. Treasury. If deductions were based upon fair market value, the Treasury would also experience a loss. In calculating fair market

value, it was assumed premium rates might increase by 41 per cent. This is due to the fact that more large corporations may be inclined to self-insure -- and would do so for a larger percentage of product liability coverage. If these large corporations no longer insure with conventional insurance companies at present levels, premium rates could increase.

One of the proposals before Congress amends Section 537 of the Internal Revenue Code to allow amounts accumulated in the loss reserve account or paid to a captive insurer to be deductible. There is a loss to the Treasury in this instance in addition to losses from deductions for contributions to a reserve and from the reserve's investment income. For 856 large corporations, we estimate the loss to the Treasury at $4 billion.

Under S. 3049, which provides deductions for five per cent of gross receipts, the potential loss to the Treasury would be $12.3 billion if 856 corporations chose to self-insure totally. The loss could increase to $23.2 billion if 300 manufacturers of all sizes were to self-insure. Under Part B of S. 3049, which allows deductions for two per cent of gross receipts, the loss to the Treasury could be $9.4 billion if 856 corporations chose to self-insure totally. If 300 manufacturers of various size self-insured, the potential loss would be $6.6 billion.

Again, I regret sincerely my absence from the country August 28. Enclosed is a copy of my study. I respectfully request that it be entered in the record of your hearings on product liability self-insurance. We would be glad to respond to any questions from you or your staff, or from the staff of the Joint Committee on Taxation.

Sincerely yours,

Andrew F. Brimmer

AFB:wb

Enclosure: Report

ATTACHMENT E

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TAX INCENTIVES AND SELF-INSURANCE AGAINST PRODUCT LIABILITY

Report by

BRIMMER & COMPANY, INC.
Economic and Financial Consultants

Prepared for

AMERICAN INSURANCE ASSOCIATION

August 15, 1978

Preface

This report was prepared at the request of the American Insurance Association. The task was to estimate the potential loss in revenue to the U.S. Treasury if Federal legislation were adopted to allow self-insured product liability reserves set aside by U.S. corporations to be treated as tax deductible.

In carrying out the assignment, we received considerable assistance from representatives of the Association (particularly Mr. Walter D. Vinyard, Jr., Counsel in the Association's Washington Office). However, the analysis undertaken and conclusions reached are our own responsibility.

At my invitation, and with guidance from me, Mrs. Constance Newman (of the Newman & Hermanson Company) and Mrs. G. Lorch Nimetz (who served as a Consultant to BRIMMER & COMPANY) designed the analytical framework within which the assignment was carried out. Mrs. Newman also had day-to-day managerial responsibility for the project. Ms. Marie Murray (Assistant Vice President) served as my alternate in maintaining an overview of the work.

In addition, a considerable amount of effort was required to gather the statistics on which the estimates are based. Working under Mrs. Newman's supervision, Miss Irene Bick, Miss Geraldine Sumter, and Ms. Judith Hermanson took the lead in making the calculations and in data analysis. Miss Loretta Dumas, Ms. Tammar Zeheb, Miss Gail Andra Shade, Miss Elveta Martin, and Ms. Ingrid Barlow, served as Research Assistants. Mrs. Grace Stewart was responsible for administrative coordination.

I have had overall responsibility for the assignment--including the final version of the report.

Andrew F. Brimmer
President

TABLE OF CONTENTS

SECTION	PAGE
I. INTRODUCTION	1
Purpose and Organization of Report	5
II. ANALYTICAL FRAMEWORK AND DATA SOURCES	6
Strategic Assumptions	7
Types of Estimates and Data Sources	10
Estimate of Present Deductions	14
III. ESTIMATES OF REVENUE LOSS TO U.S. TREASURY	16
Proposition I: Ordinary Risk	16
Proposition II: Ordinary Plus Severe Risk	24
Proposition III: Fair Market Value	30
Proposition IV: Fair Market Value Plus Reserve and Investment Income	39
Proposition V: Dollar Limitation vs. Severity of Risk Plus Reserve and Investment Income	51
IV. SUMMARY AND CONCLUSIONS	61
Estimating Technique	62
Losses to the U.S. Treasury	63
Summary of Specific Alternatives	69
Concluding Observations	72

LIST OF TABLES

TABLE		PAGE
1.	Potential Deductions for Product Liability Insurance Coverage Under Ordinary Risk. . . 856 Corporations	18
2.	Potential Loss to the U.S. Treasury for Product Liability Insurance Coverage Under Ordinary Risk . . . 856 Corporations	19
3.	Potential Deductions for Product Liability Insurance Coverage Under Ordinary Risk . . . 300 Firms	22
4.	Potential Loss to the U.S. Treasury for Product Liability Insurance Coverage Under Ordinary Risk . . . 300 Firms	23
5.	Potential Loss to U.S. Treasury for Product Liability Insurance Coverage Under Ordinary Risk . . . Industries Represented by 300 Firms	24
6.	Potential Deductions for Product Liability Insurance Coverage Under Severe Risk ... 856 Corporations	28
7.	Potential Loss to the U.S. Treasury for Product Liability Insurance Coverage Under Severe Risk . . . 856 Corporations	29
8.	Potential Deductions for Product Liability Insurance Coverage Under Severe Risk ... 300 Firms	31
9.	Potential Loss to the U.S. Treasury for Product Liability Insurance Coverage Under Severe Risk . . . 300 Firms	32
10.	Potential Loss to U.S. Treasury for Product Liability Coverage Under Ordinary Risk . . . Industries Represented by 300 Firms	33
11.	Potential Deductions for Product Liability Insurance. . . Fair Market Value . . . 856 Corporations	36
12.	Potential Loss to the U.S. Treasury for Product Liability Insurance...Fair Market Value...856 Corporations	37

LIST OF TABLES (cont'd)

TABLE PAGE

13. Potential Deductions for Product Liability Insurance...Fair Market Value...300 Firms 40

14. Potential Loss to U.S. Treasury for Product Liability Insurance...Fair Market Value... 300 Firms 41

15. Potential Loss to U.S. Treasury for Product Liability Insurance...Fair Market Value... Industries Represented by 300 Firms 42

16. Potential Deductions for Product Liability Insurance...Fair Market Value...Plus Reserve and Investment Income...856 Corporations 45

17. Potential Loss to the U.S. Treasury for Product Liability Insurance...Fair Market Value...Plus Reserve and Investment Income...856 Corporations . 46

18. Potential Deductions for Product Liability Insurance...Fair Market Value...Plus Reserve and Investment Income...300 Firms 48

19. Potential Loss to U.S. Treasury for Product Liability Insurance...Fair Market Value...Plus Reserve and Investment Income...300 Firms 49

20. Potential Loss to U.S. Treasury for Product Liability Insurance...Fair Market Value... Plus Reserve and Investment Income... Industries Represented by 300 Firms 50

21. Potential Deductions for Product Liability Insurance...Dollar Limitations vs. Severity of Risk...856 Corporations 55

22. Potential Loss to U.S. Treasury for Product Liability Insurance...Dollar Limitations vs. Severity of Risk...856 Corporations 56

23. Potential Deductions for Product Liability Insurance...Dollar Limitations vs. Severity of Risk Plus Reserve and Investment Income ...300 Firms 58

LIST OF TABLES (cont'd)

TABLE		PAGE
24.	Potential Loss to U.S. Treasury for Product Liability Insurance...Dollar Limitations vs. Severity of Risk Plus Reserve and Investment Income...300 Firms.	59
25.	Potential Loss to U.S. Treasury for Product Liability Insurance...Dollar Limitations vs. Severity of Risk Plus Reserve and Investment Income...Industries Represented by 300 Firms.	60
26	Summary of the Potential Deductions and Loss to the U.S. Treasury for Product Liability Insurance...Various Alternatives...856 Corporations	64
27	Summary of the Potential Deductions and Loss to the U.S. Treasury for Product Liability Insurance...Various Alternatives...300 Firms...Industrial Classes	67
28	Summary of the Potential Deductions and Loss to the U.S. Treasury for Product Liability Insurance...Various Alternatives...300 Firms . .	68
29	Summary of the Potential Loss to the U.S. Treasury for Product Liability Insurance... Various Alternatives...All Industries Represented by 300 Firms	70

APPENDIX TABLES

TABLE		PAGE
A.	Sales Ranking of 856 Large Corporations, 1977	73
B.	Distribution of 300-Company Sample, By Size of Sales, 1977.	87

APPENDIX TABLES (cont'd)

TABLE | PAGE

C. Value of Shipments of Selected Manufacturing Industries, 1977. 88

D. Manufacturer's Sales (Shipments), By Major Industry Group, 1976. 92

E. Product Liability Rates for Target Product Categories. 93

SECTION I

INTRODUCTION

In recent years, a controversy has developed regarding the availability and cost of product liability insurance. A number of manufacturers have alleged that such coverage has become unavailable or unaffordable. These charges have been echoed in editorials in business publications. On the other hand, spokesmen for the insurance industry have attempted to refute the claims.

In response to the intense interest in the status of product liability, an Interagency Task Force on Product Liability (ITFPL) was established by the Federal Government in April, 1976. After a great deal of probing, the Task Force issued its report in 1977. 1/ The group's key conclusions can be summarized briefly:

> (1) "There is no widespread problem of product liability insurance being unavailable. A few companies in the Task Force's target industries and other high-risk product lines are having difficulty obtaining product liability insurance. For some others, product liability rates would appear to be unaffordable-- it has been persuasively argued to the Task Force that this is a practical equivalent of unavailability." 2/

1/ U.S. Department of Commerce, Interagency Task Force on Product Liability: Final Report, 1977. (Referred to below as Final Report).

2/ Final Report, Vol. Id., p. xxxv.

(2) "There has been a substantial increase in the cost of product liability insurance since 1974 in all of the Task Force's target industries. The increase in premiums appears to have been greater for small as compared to large businesses. Also, small firms appear less able to cope with affordability problems than large firms. Certain industries appear to have been subject to very substantial increases. These include manufacturers of medical devices, pharmaceuticals, power lawnmowers, industrial chemicals, and metal castings." 3/

In contrast, many representatives of the insurance industry have argued that there is no basis for claiming that product liability insurance is either unavailable or unaffordable in the United States. To support their position, they supplied a considerable amount of documentation to the Task Force.[4/]

Aside from the differences as to the nature and extent of the obstacles to obtaining product liability coverage, there are also differences with respect to the best way to cope with the situation. One approach currently under consideration in both the Carter Administration and the Congress would modify present Federal Government tax policy and legislation to permit corporate taxpayers to make deductions for the cost of self-insurance for product liability losses. A number of bills have already been introduced in the Congress

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3/ Final Report, Vol. Id., p. xxxvi.

4/ U.S. Department of Commerce, Interagency Task Force on Product Liability: Final Report of the Insurance Study, 1977, Vol. I, pp. 4-32. (Referred to below as Industry Study).

to achieve this goal, and others have been drafted for consideration.

Most of the suggestions have several features in common. These are:

(1) A provision to amend Section 165 of the Internal Revenue Code of 1954 so that deductions for contributions to a reserve (trust) for product liability losses are allowed.

(2) A provision to allow the expenditure of funds in the reserve/trust account to pay future product liability claims and related administrative expenses.

(3) A provision to establish a limitation on the amount paid into the reserve account which would be tax deductible. Some of the propositions establish a numerical formula limiting the amount deductible to a percentage of annual gross receipts; others use descriptive terms to define the level of maximum deductions such as "fair market value" and "reasonable cost."

Some of the propositions also include the following variations:

(1) A provision to allow a tax deduction for the income derived from investment of the assets of a taxpayer's product liability loss reserve account.

(2) A provision to amend Section 537 of the Internal Revenue Code so that amounts accumulated in the loss reserve account would not be subject to accumulated earnings tax.

(3) A provision to allow a tax deduction for a portion of payments to a captive insurer for product liability coverage not now allowed under the Internal Revenue Code of 1954.

The idea of allowing a tax deduction for self-insurance was also considered by the Interagency Task Force. It

indicated that:

> "It has been suggested to the Task Force that a possible method of helping to alleviate product liability insurance availability problems for small businesses would be to permit them to set aside a portion of their pre-tax income to fund a specific reserve . . . (T)here are a number of difficulties with self-insurance as a product liability remedy. First, in light of its potential impact on the tax revenue of the Federal Government, strong policy reasons would be needed to justify it." 5/

> ". . . the Task Force did not have the opportunity to have the Department of the Treasury undertake a full tax evaluation of this particular remedy. 5/

Apparently, the U.S. Treasury itself still has not made an estimate of the potential loss of revenue that might result from the adoption of the self-insurance approach to compensate for the risk of product liability. Yet, such an amendment to the Internal Revenue Code may have an adverse impact on the Federal Treasury. Moreover, there is also a possibility that the adoption of one or more of the proposals described above would reduce tax receipts of a number of State governments. In addition to income and real and personal property taxes, a substantial number of states also levy special taxes on insurers. The most important of these is the premium tax. The majority of States tax the gross premiums (usually about 3 per cent) collected by property and liability insurance companies. 6/

5/ Task Force, Final Report, VII, p. 169

6/ S.S. Huebner, K. Black, Jr., and R.S. Cline, Property and Liability Insurance, Second Edition, 1976, p. 681.

Purpose and Organization of Report

The present report was undertaken to provide at least a rough estimate of the potential revenue costs to the U.S. Treasury if tax incentives for self-insurance against product liability losses are adopted.

The report is organized as follows: In Section II, the analytical framework, estimating techniques, and data sources used are discussed. Estimates of revenue loss to the U.S. Treasury are presented in Section III. The estimates are calculated for five different variations of the self-insurance approach. Finally, a summary and the key conclusions of the study are presented in Section IV. Some of the basic data used in the study are contained in the Appendix.

SECTION II

ANALYTICAL FRAMEWORK AND DATA SOURCES

The estimates of tax revenue losses which might result from the adoption of tax incentives for self-insurance against product liabilities have been derived on the basis of a number of assumptions and by reliance on a variety of data sources. These assumptions and sources of information are described in this section.

It was assumed that the Congress might enact some type of proposal to amend the Internal Revenue Code of 1954 to provide for corporate deductions for self-insurance against product liability losses. This could be done in a variety of ways, and a number of bills have been introduced to provide some form of Federal tax incentive for self-insurance. In this study, five different propositions were assessed. The essential characteristics of the five alternatives with respect to the Federal treatment of tax deductions for self-insurance can be summarized as follows:

Proposition I.	Ordinary risk (2 per cent of gross receipts).
Proposition II.	Ordinary plus severe risk (5 per cent of gross receipts).
Proposition III.	Fair market value.

Proposition IV.	Fair market value plus reserve and investment income.
Proposition V.	Dollar limitation vs. severity of risk plus reserve and investment income.

Strategic Assumptions

The detailed features of each of these alternatives are described in connection with the presentation of the specific estimates. However, a number of key assumptions are common to most of the latter, and they should be kept in mind.

(1) Any estimate of potential revenue losses to the U.S. Treasury must be derived from a comparison between the amount of deductions for liability insurance which taxpayers are currently making and the amount of such deductions which they might take in the future--if tax incentives were adopted. Such a comparison would require an analysis of potential deductions taken by firms for payment of premiums to conventional insurance companies, for allowable self-insurance expenses, and for payments to the captive insurance companies under the present provisions of the tax code.

To estimate these amounts directly, it would have been necessary to undertake a canvass of all business taxpayers. But, because of a lack of time and resources, such a survey could not be carried out. Instead, the estimates had to be gotten on the basis of an indirect approach. Thus, it was

assumed that premiums paid property and casualty insurance companies for liability coverage (and deducted for tax purposes) would vary systematically with the level of a firm's sales. Initially, it was also assumed that businesses exposed to product liability would seek full coverage.

(2) Of course, not all corporations would choose to self-insure--even with a tax incentive. Many of the smaller firms could not afford to self-insure. They do not have the capital to pay large product claims, and one loss could exceed one year's total sales. Moreover, such firms do not have captive insurance companies, and commercially available product liability policies do not have deductibles. Whenever available at reasonable cost, the smaller firms will probably continue to purchase insurance--already a tax deduction.

The above considerations suggest that the U.S. Treasury is not likely to lose much revenue because small firms choose to self-insure. To change the situation, tax incentive proposals would have to be designed specifically for small businesses. Thus, the large corporations are the ones most likely to self-insure--thereby creating the revenue losses for the Federal Government.

(3) Even if the most liberal tax incentive were enacted, it is improbable that all corporate taxpayers would be prepared to absorb 100 per cent of the product liability claims it could face. Most of the large companies will probably set a ceiling on self-insurance and cover the remaining risk by purchasing

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insurance in the marketplace.

A rough idea of the likely division between self-insurance and purchased coverage can be gotten from the *Fortune* Market Research Survey for 1973, which collected data on *Fortune*'s 500 top corporations. In that year, 14 per cent of the companies retained 25 per cent or more of their total risk. Sixty-six per cent said they planned to increase their retentions. Nearly 40 per cent of the second *Fortune* 500 companies had similar plans. These benchmarks suggest that large firms--on average--might retain at least 25 per cent of product liability risk--although a much higher percentage might actually emerge under a scheme of tax incentives. For the present study, the proportion was assumed to be in the range of 25 per cent to 30 per cent.

(4) In estimating the potential impact on the U.S. Treasury--if one of the various tax incentive proposals were enacted into law--several types of industries were excluded. They were financial institutions (including insurance companies) and publishing firms. They were excluded from the analysis because their exposure to product liability claims is much less than that faced by the average manufacturing enterprise. In addition, for the corporations included in the study, no estimates were made of the product liability premiums paid for services.

Types of Estimates and Data Sources

To provide an appreciation of the range of potential effects of the various tax incentives on the United States Treasury, two (2) different estimates were provided. The calculations were derived on the following assumptions:

(1) Only large firms would take advantage of the new opportunity to self-insure.

(2) A variety of firms of all sizes with product liability problems would self-insure.

In addition, two (2) projections were made to provide a rough indication of the potential impact of the alternative proposals on those industries which face significant product liability exposure and on the economy as a whole. The projections were for:

(1) Ten industry groups represented by the firms identified in (2) above.

(2) All manufacturing firms in the United States combined.

To assess the impact of the tax incentives if only large businesses were to self-insure, the analysis began with the top 1,000 firms in Fortune's 1978 list. Sales and product data for each company, covering 1976 and 1977, were compiled from Form 10-K filed with the Securities and Exchange Commission (SEC). In the process of compiling data, 144 companies were excluded. Eighty (80) of these were excluded because Form 10-K's were not available or the company had merged. Sixty-four (64) were excluded because they were financial institutions (banks, insurance companies, etc.) or were providing services. These

exclusions left 856 companies for which data could be used in the analysis.

These 856 firms had factory sales of $1,019,050 million in 1977. In the same year, total business sales (manufacturing and trade) amounted to $2,677,787 million. Thus, the 856-company sample represented 38.1 per cent of economy-wide sales. (The individual companies, by sales ranking in 1977, are listed in Appendix Table A.)

The sales figures for each company were used as the base, and the assumed percentage premium rates were used as multipliers, to calculate the potential deduction for self-insurance. In determining present deductions, 0.34 per cent was used for products carrying ordinary risk of generating product liability; the rates identified by the Interagency Task Force were used for severe risk of exposure.

To estimate the impact if a variety of firms of all sizes were to self-insure, a random sample of 300 firms was selected from those listed in the 1978 Dun and Bradstreet Million Dollar Directory, which lists most companies with sales of $1 million and over. All of these were manufacturing firms, and they had total sales of $91,792 million in 1977. In the same year, total manufacturing sales amounted to $1,327,341 million. Thus, the 300-company sample represented 6.9 per cent of sales by all manufacturers.

The 300-company sample was designed to represent 10 industrial classes. Nine of these contained products identified by the Interagency Task Force as posing potential product

liability insurance problems. These products are (1) industrial machinery; (2) grinding wheels; (3) ferrous and nonferrous metal castings; (4) industrial chemicals; (5) aircraft components; (6) automotive components; (7) medical devices; (8) pharmaceuticals; and (9) power lawnmowers. A tenth (10th) category contained those firms not fitting into either of the above classifications.

The companies were also selected on the basis of size, as determined by 1977 sales: (1) under $2.5 million; (2) $2.5 to $100 million; and (3) over $100 million. Each size group contained 100 companies. Originally, the intention was to select 30 companies for each of the 10 industrial classes, with the 30 firms in turn distributed equally among the three size classes. This scheme was generally followed. But, as shown in Appendix Table B, this could not be done in every case. However, 270 of the firms in the 300-company sample manufactured one or more items in the nine product categories which pose some degree of product liability.

In determining present deductions, 0.34 per cent was used for products carrying ordinary risk of generating product liability; the rates identified by the Interagency Task Force were used for severe risk of exposure.

The next task was to obtain data which would permit the projection of the estimates to industry- and economy-wide levels if a variety of firms were to self-insure at least part of their risk. Both projections were based on data for firms

in the 300-company sample.

In the first projection, the task was to use the previously derived deductions for the 300 companies to estimate deductions for those industries in which a number of firms produce items carrying significant product liability exposure. For this purpose, 1977 sales data for 140 manufacturing industries were used. These industries were listed in U.S. Department of Commerce, _U.S. Industrial Outlook, 1978_. The industries were distributed (on the basis of the Standard Industrial Classification Code--SIC) among the 10-group categories into which the 300-company sample had been divided. (The 140 industries are shown in Appendix Table C.) For each of the 10 classes, the value of industry sales (shipments) in 1977 was calculated. The premium/sales ratios previously calculated for the firms in the 300-company sample were then used to estimate the potential loss to the U.S. Treasury through self-insurance--if the deductions were confined largely to those _industries_ in which firms produce items carrying significant product liability risks.

In the second projection, the task was to use the premium/sales ratios previously calculated for the 300-company sample to derive estimates of the potential loss to the U.S. Treasury--if _all_ manufacturing firms elected to rely to some degree on self-insurance against claims arising from product liability. For this purpose, the value of sales (shipments) in 1976 by all manufacturers was used as the base. (These

sales, by major industry group, are shown in Appendix Table D.) The calculations were carried out in the same way as described above.

Estimate of Present Deductions

In order to determine the potential impact of the various alternatives on the U.S. Treasury, it was first necessary to estimate the current deductions taken by firms for premiums paid to conventional insurance companies. Since this study did not involve a canvass of business taxpayers, the estimates had to be developed indirectly. For the 856 corporations with sales of $100 million and over, and for the 300 firms selected at random and the industries they represent, the calculations were made as follows:

(1) Deductions for premiums paid to conventional insurance companies were calculated by taking product liability premium rates as a percentage of sales. For the products in the target product categories defined by the Interagency Task Force, the rates identified by the latter for each product were used. (These rates are shown in Appendix Table E.) For all other product categories, .34 per cent was applied to the corporate sales figure. (The source of the .34 per cent was the Industry Study of Product Liability for the Interagency Task Force, Table 4-8, Primary Product Liability Cost per $1,000 sales.)

(2) Having calculated the potential deductions, the loss to the United States Treasury under the present Internal Revenue Code was estimated. It was assumed that, without the deductions allowed under a specific tax incentive, the tax paid to the United States Treasury would have been 20 per cent on the first $25,000, plus 22 per cent on the next $25,000, and 26 per cent surtax on the excess over $50,000.

The premium rates used in the estimation of the amount of premiums paid by all corporations (including the top *Fortune* 500) did not allow for any deviation in total premiums paid as a result of the size of the firm purchasing the coverage. An alternative calculation with a credit (or discount) for the size of the customer firm would result in an increase in the loss to the U.S. Treasury under the various propositions. There is substantial evidence to indicate that the cost of product liability insurance (measured in terms of premiums per thousand dollars of sales) is generally much lower for the larger firms.[7/] However, despite extensive probing among representatives of insurance companies which sell product liability coverage--as well as among representatives of firms which buy it--it was not possible to obtain good estimates of the magnitude of these deviations from generally quoted premium rates.

SECTION III

ESTIMATES OF REVENUE LOSS TO U.S. TREASURY

In this section, the estimates of potential revenue loss to the U.S. Treasury are presented -- on the assumption that some form of tax incentive for self-insurance against product liability might be enacted. The estimates are calculated for each of the alternative approaches described above.

Proposition I: Ordinary Risk

Under this proposition, taxpayers would be allowed tax deductions for contributions to a product liability loss reserve account. The amount of the deductions could not exceed 2 per cent of the taxpayer's gross receipts for the taxable year from the manufacture, importation, distribution, lease, or sale of any item which may expose the firm to any product liability. The 2 per cent figure was taken as a rough measure of ordinary risk.

For purposes of this report, net sales figures were used rather than gross receipts. The sales data are readily available from the Form 10-K which corporations file with the Securities and Exchange Commission. Moreover, in many instances, there is little difference between net sales and gross receipts from the sale of a product.

Once the deductions under this proposition were determined, the loss to the U.S. Treasury was calculated. Two types of estimates of the potential loss are provided. The first set of

calculations was done on the assumption that only large firms would self-insure. The sample of 856 firms discussed above was the source of information for this part of the analysis. The second set of calculations was done on the assumption that a variety of firms of all sizes would choose to self-insure. The 300-company sample was the basis of this phase of the inquiry.

Table 1 summarizes the estimates of the potential deductions if the large companies take advantage of the tax incentives that might be provided to cover ordinary product liability risk through self-insurance. Information is also presented which shows the difference in maximum deductions allowable under Proposition I compared with the present law. Table 2 presents estimates of the potential loss to the U.S. Treasury -- if the available deductions recorded in Table 1 were actually taken.

The deductions shown in Table 1 and the loss to the Treasury in Table 2 were calculated for four different levels of participation in the self-insurance activity. If all of the 856 large companies were to participate fully, the potential deductions under Proposition I might amount to $20.4 billion. Under the present Internal Revenue Code, the potential deductions for premiums (if these 856 firms insured with conventional insurance companies) were estimated at $5.8 billion. Thus, as shown in Table 2, the loss to the Treasury was estimated at $9.8 billion under Proposition I.

The above estimates were derived on the assumption that all of the 856 large corporations participated fully in a self-insurance activity. However, it is conceivable that only some of the firms

TABLE 1. Potential Deductions for Product Liability Insurance Coverage Under Ordinary Risk (Deductions Based on 2 Per Cent of Gross Receipts For 856 Corporations with Sales of $100 Million and Over.) 1/

Corporations	Deductions 100 per cent self-insurance	(In millions of dollars) 90 per cent self-insurance	60 per cent self-insurance	10 per cent self-insurance
Under Proposition 1				
For 100 Corporations	3,274	2,947	1,964	982
For 200 Corporations	5,148	4,633	3,089	1,544
For 300 Corporations	8,889	8,000	5,333	2,667
For 400 Corporations	11,316	10,184	6,790	3,395
For 500 Corporations	13,451	12,106	8,071	4,035
For 600 Corporations	15,496	13,946	9,298	4,649
For 700 Corporations	17,050	15,345	10,230	5,115
For 856 Corporations	20,381	18,343	12,229	6,114
Under the Present Law				
For 100 Corporations	445	445	445	445
For 200 Corporations	1,064	1,064	1,064	1,064
For 300 Corporations	2,311	2,311	2,311	2,311
For 400 Corporations	3,045	3,045	3,045	3,045
For 500 Corporations	3,851	3,851	3,851	3,851
For 600 Corporations	4,386	4,386	4,386	3,386
For 700 Corporations	4,944	4,944	4,944	4,944
For 856 Corporations	5,769	5,769	5,796	5,796
Difference between present law and Proposition				
For 100 Corporations	2,829	2,502	1,519	537
For 200 Corporations	4,084	3,569	2,025	480
For 300 Corporations	6,578	5,689	3,022	356
For 400 Corporations	8,271	7,139	3,745	350
For 500 Corporations	9,600	8,255	4,220	184
For 600 Corporations	11,110	9,560	4,912	263
For 700 Corporations	12,106	10,401	5,286	171
For 856 Corporations	14,612	12,574	6,460	345

1/Calculations by BRIMMER & COMPANY from: 1) Sales data provided by the 856 corporations on Form 10-K filed with the Securites and Exchange Commission; and 2) Product Liability Insurance premium rates from the Insurance Study Final Report, Interagency Task Force on Product Liability.
2/The corporations were divided into groups of 100, each group containing companies of various size and manufacturing a variety of product.
3/Figures are cumulative.

Table 2. Potential Loss to the U.S. Treasury for Product Liability Insurance Coverage Under Ordinary Risk (Deductions Based on 2 Per Cent of Gross Receipts for 856 Corporations with Sales of $100 Million and Over.) 1/

Corporations 2/	Loss (in millions of dollars) 3/			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self-insurance
Under Proposition I				
For 100 Corporations	1,570	1,413	942	471
For 200 Corporations	2,468	2,221	1,481	740
For 300 Corporations	4,263	3,837	2,558	1,279
For 400 Corporations	5,426	4,883	3,256	1,628
For 500 Corporations	6,450	5,805	3,870	1,935
For 600 Corporations	7,430	6,687	4,458	2,229
For 700 Corporations	8,175	7,358	4,905	2,453
For 856 Corporations	9,771	8,794	5,863	2,931
Under the Present Law				
For 100 Corporations	212	212	212	212
For 200 Corporations	508	508	508	508
For 300 Corporations	1,105	1,105	1,105	1,105
For 400 Corporations	1,456	1,456	1,456	1,456
For 500 Corporations	1,841	1,841	1,841	1,841
For 600 Corporations	2,096	2,096	2,096	2,096
For 700 Corporations	2,363	2,363	2,363	2,363
For 856 Corporations	2,757	2,757	2,757	2,757
Difference between present law and Proposition				
For 100 Corporations	1,358	1,201	703	259
For 200 Corporations	1,960	1,713	973	232
For 300 Corporations	3,158	2,732	1,453	174
For 400 Corporations	3,970	3,427	1,800	172
For 500 Corporations	4,609	3,964	2,029	94
For 600 Corporations	5,334	4,591	2,362	133
For 700 Corporations	5,812	4,995	2,542	90
For 856 Corporations	7,014	6,037	3,106	174

1/Calculations by BRIMMER & COMPANY from deductions as reported--in Table 1, using a tax rate for each corporation of 20 per cent of the first $25,000; 22 per cent of the second $25,000; and 48 per cent of the balance.

2/The corporations were divided into groups of 100, each group containing companies of various sizes and manufacturing a variety of products.

3/Figures are cumulative.

would take part, but they might do so to a limited extent. To allow for these possibilities, calculations were made which matched the extent of participation with the proportion of allowable deductions actually taken. The number of companies were divided into groups of 100 -- each group containing firms of various size and manufacturing a variety of products. Four levels of allowable deductions were assumed: 100 per cent; 90 per cent; 60 per cent, and 30 per cent. The estimates of the potential deductions for combinations of participation and percentage of allowable deuctions taken are shown in Table 1, and the potential losses to the U.S. Treasury are shown in Table 2.

These calculations are based on the assumption that the companies would not supplement their self-insurance with coverage by conventional insurance companies. In all probability, that would not be the case. Consequently, any level of participation of less than 100 per cent would most likely result in an under-estimation of the loss to the Treasury. At 90 per cent participation, the loss attributed to the 856 companies is estimated at $8.8 billion; at 60 per cent participation it is $5.9 billion, and at 30 per cent participation it is $2.9 billion.

However, there are sub-groups among the 856 firms where participation in a program of self-insurance based on allowable deductions of 2 per cent of sales would result in revenue gains to the Treasury. These gains accrue when the products manufactured by the taxpayer are in the "severe" product liability category; the present premium

rates are above 0.34 per cent, and corporations do not supplement their self-insurance coverage with conventional insurance.

Tables 3 and 4, respectively, contain the estimates of the potential deductions and revenue losses to the Treasury -- if the members of the 300-firm sample were to self-insure under Proposition I. Of these 300 enterprises, 270 fall into industries identified by the Interagency Task Force as facing potentially serious product liability problems.

If all of these firms were to participate fully in the program, the potential deductions for tax purposes could amount to $1.9 billion. The largest potential deductions ($427 million) would be available to firms in the metal casting industry; the smallest ($90 million) would accrue to firms producing automotive components.

Potential revenue loss to the Treasury would be around $895 million -- if all of the 300 firms were to participate fully. The losses would be distributed among firms in the different industry groups in the same pattern described for potential deductions.

As explained above, the figures for the 300-company sample were used to estimate the net loss to the U.S. Treasury if the entire industry represented by the sample of firms in that particular industry chose to self-insure under Proposition I. The projection from 300-firm sample to the industry level was based on value of shipments by selected manufacturing industries in 1977 -- as explained in Section II. The results are shown in Table 5, panel(a). If 100 per cent self-insurance were to prevail, the potential loss to the Treasury would amount to $4.1 billion. As the level of

TABLE 3. Potential Deductions for Product Liability Insurance Coverage Under Ordinary Risk (Deductions Based on 2 Per Cent of Sales Representing Gross Receipts for a Random Sample of 300 Firms) 1/

	Deductions (in millions of dollars)			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self insurance
nder Proposition I				
Industrial machinery	94	84	56	28
Grinding wheels	164	147	98	49
Ferrous castings	427	384	256	128
Industrial chemicals	256	230	154	77
Aircraft components	230	207	138	69
Auto components	90	81	54	27
Medical devices	204	184	123	61
Pharmaceuticals	168	151	101	50
Lawnmowers	144	130	86	43
Other	96	87	58	29
TOTAL	1,873	1,685	1,124	561
'nder Present Law				
Industrial machinery	43	43	43	43
Grinding wheels	75	75	75	75
Ferrous castings	156	156	156	156
Industrial chemicals	114	114	114	114
Aircraft components	94	94	94	94
Auto components	64	64	64	64
Medical devices	90	90	90	90
Pharmaceuticals	73	73	73	73
Lawnmowers	65	65	65	65
Other	14	14	14	14
TOTAL	788	788	788	788
)'fference between 'resent Law and 'roposition I				
Industrial machinery	51	41	13	- 15
Grinding wheels	88	72	23	- 26
Ferrous castings	272	230	102	- 27
Industrial chemicals	142	116	40	- 37
Aircraft components	136	113	44	- 25
Auto components	26	17	-10	- 37
Medical devices	114	94	32	- 29
Pharmaceuticals	95	78	28	- 23
Lawnmowers	79	65	22	- 21
Other	82	72	43	+ 14
TOTAL	1,085	897	336	-227

1/Calculations by BRIMMER & COMPANY from: 1) Sales figures in the 1978 Dun & Bradstreet Directory, 2) Product Liability Insurance Premium rates from the Insurance Study Final Report, Interagency Task Force on Product Liability.

TABLE 4. Potential Loss to the[23] U.S. Treasury for Product Liability Insurance Coverage Under Ordinary Risk (Deductions Based on 2 Per Cent of Sales Representing Gross Receipts for a Random Sample of 300 Firms) 1/

	Loss	(in millions of dollars)		
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self insurance
Under Proposition I				
Industrial machinery	44	40	27	13
Grinding wheels	78	70	47	23
Ferrous castings	205	184	123	61
Industrial chemicals	123	111	74	37
Aircraft components	110	99	66	33
Auto components	43	39	26	13
Medical devices	98	88	59	29
Pharmaceuticals	80	72	48	24
Lawnmowers	69	62	41	21
Other	45	41	27	14
TOTAL	895	806	538	268
Under Present Law				
Industrial machinery	20	20	20	20
Grinding wheels	36	36	36	36
Ferrous castings	74	74	74	74
Industrial chemicals	54	54	54	54
Aircraft components	45	45	45	45
Auto components	31	31	31	31
Medical devices	43	43	43	43
Pharmaceuticals	34	34	34	34
Lawnmowers	31	31	31	31
Other	6	6	6	6
TOTAL	374	374	374	374
Difference between Present Law and Proposition I				
Industrial machinery	24	20	7	- 7
Grinding wheels	42	34	11	-12
Ferrous castings	131	110	49	-12
Industrial chemicals	69	57	20	-17
Aircraft components	65	54	21	-12
Auto components	12	8	-5	-18
Medical devices	55	45	16	-14
Pharmaceuticals	46	37	13	-11
Lawnmowers	38	31	11	-10
Other	39	35	21	7
TOTAL	521	436	164	-106

1/ Calculations by BRIMMER & COMPANY from deductions as reported in Table 3 using a tax rate for each firm, 20 per cent of the first $25,000; 22 per cent of the second $25,000; and 48 per cent of the balance.

participation declined, the loss would decrease as follows: 90 per cent, $3.6 billion; 60 per cent, $2.4 billion, and 30 per cent, $1.2 billion.

For the entire manufacturing sector, the potential revenue loss to the U.S. Treasury might amount to $6.7 billion under Proposition I, as shown in Table 5, panel(b). (This estimate is based on manufacturers' shipments, by major industry group in 1976 -- as explained above). At 90 per cent self-insurance, the potential loss is $6.0 billion; at 60 per cent it is $4.0 billion, and at 30 per cent it is $2.0 billion.

Proposition II: Ordinary Plus Severe Risk

Under this proposition taxpayers would be allowed annual tax deductions for contributions to a product liability loss reserve account not to exceed:

(1) 5 per cent of the gross receipts of the taxpayer for the taxable year from the manufacture, importation, distribution, lease or sale of a product where the taxpayer qualifies as having a severe product liability problem ("Severe Risk"); and

(2) 2 per cent of the gross receipts of the taxpayer for the taxable year from the manufacture, importation, distribution, lease or sale of products where the taxpayer does not qualify as having a severe product liability problem ("Ordinary Risk").

In at least one of the self-insurance proposals advanced, a taxpayer qualifies as having a severe product liability problem if one of the following situations prevails during a taxable year: (a) the taxpayer was unable to obtain a premium quotation for product liability insurance, with coverage of up to

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TABLE 5. Potential Loss to U.S. Treasury for Product Liability Insurance Coverage Under Ordinary Risk (Deductions Based on 2 Per Cent of Gross Receipts for Industries Represented by the 300 Firms) 1/

	Loss to Treasury (in millions of dollars)			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self-insurance
(a) Under Proposition I 2/ (Selected industries guide)				
Industrial machinery	362	326	217	109
Grinding wheels	*	*	*	*
Ferrous castings	315	284	189	95
Industrial chemicals	222	200	133	67
Aircraft components	48	43	29	14
Auto components	176	158	106	53
Medical devices	44	40	26	13
Pharmaceuticals	73	66	44	22
Lawnmowers	*	*	*	*
Other	2,810	2,529	1,686	843
TOTAL	4,050	3,645	2,430	1,215
(b) (Manufacturers' Sales Guide) 3/				
Industrial machinery	927	834	556	278
Grinding wheels	*	*	*	*
Ferrous castings	536	187	125	62
Industrial chemicals	208	482	322	161
Aircraft components	**	**	**	**
Auto components	663	597	398	199
Medical devices	*	*	*	*
Pharmaceuticals	*	*	*	*
Lawnmowers	*	*	*	*
Other	4,323	3,891	2,594	1,297
TOTAL	6,657	5,991	3,995	1,997

* Total industry figures not available, hence included in "other" category.
** Estimate combined with "auto components" below, representing the transportation equipment industry.

1/ Calculations by BRIMMER & COMPANY from the losses as reported in Table 4.

2/ Estimated loss based on "value of shipments" by selected manufacturing industries in 1977, reported in U.S. Department of Commerce, U.S. Industrial Outlook, 1978, Appendix A, pp. 465-468.

3/ Estimated loss based on "Manufacturers' Sales (shipments)" by major industry group in 1976, reported in U.S. Department of Commerce, Survey of Current Business, April, 1978, pp. S-5 and S-6.

$1,000,000, from any insurer other than a captive insurer; or (b) the lowest insurance premium quotation for product liability insurance with coverage of up to $1,000,000 obtained by the taxpayer was equal to more than 3.0 per cent of the gross receipts of the taxpayer for such taxable year.

Since this study did not involve a canvass of the corporations whose sales data were the foundations for the estimate, it was not possible to determine which firms qualify as having a severe product liability insurance problem as defined above. Hence, in developing the estimate, the following approach was taken: A product line was defined as having a severe product liability problem if it were so categorized by the Interagency Task Force on Product Liability. For those products, the deductions under this Proposition II were estimated by taking 5 per cent of net sales. ("Net sales" was used in lieu of "gross receipts" because it was an amount readily available in the Form 10-K filed with the Securities and Exchange Commission).

In estimating the deductions by the method employed here, the loss to Treasury may be under-estimated. It is conceivable that, under this proposition, a taxpayer will be judged as having a severe product liability insurance problem if <u>any one</u> of its products makes it difficult for the firm to obtain conventional insurance. For that taxpayer, the 5 per cent of gross receipts could be applied to all products manufactured by the enterprise. That was not the approach taken in developing the estimate presented here. Instead,

within one corporation, 5 per cent of sales was taken only of those products identified by the Interagency Task Force as having the potential of encountering serious product liability problems.

Two types of estimates of the potential loss to the Treasury under Proposition II are provided. The first estimate is of the potential loss if the 856 large corporations chose to self-insure. The second estimate is of the potential loss to the Treasury if the members of the 300-firm sample and the industries they represent participate in a self-insurance activity.

Table 6 provides the estimates of the potential deductions for the 856 corporations if they take advantage of the tax incentives provided by Proposition II. Table 6 also shows the difference in maximum deductions allowable between Proposition II and the present law. Table 7 provides estimates of the potential loss to the Treasury were the deductions shown in Table 6 to be taken.

Assuming full participation in the self-insurance activity by the 856 corporations, the potential total deductions are $31.4 billion, an increase of $25.6 billion over deductions taken under the present law. The additional loss to Treasury would be $12.3 billion. With 90 per cent participation by the large firms, the potential loss to the Treasury is $10.8 billion; at 60 per cent it is $6.3 billion, and at 30 per cent it is $1.8 billion. Allowing certain manufacturers to take 5 per cent of gross receipts raises the level of allowable deductions because few of today's product liability premiums are up to 5 per cent of such receipts.

TABLE 6. Potential Deductions for Product Liability Insurance Coverage Under Severe Risk (Deductions Based on 5 Per Cent of Gross Receipts) and Ordinary Risk (Based on 2 Per Cent of Gross Receipts) for 856 Corporations with Sales $100 Million and Over) 1/

Corporations 2/	Deductions	(In millions of dollars) 3/		
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self-insurance
Under Proposition II				
For 100 Corporations	4,543	4,089	2,726	1,363
For 200 Corporations	7,425	6,683	4,455	2,228
For 300 Corporations	11,479	12,132	8,088	4,044
For 400 Corporations	18,253	16,429	10,952	5,476
For 500 Corporations	21,522	19,371	12,914	6,457
For 600 Corporations	24,452	22,008	14,672	7,336
For 700 Corporations	27,001	24,302	16,201	8,101
For 856 Corporations	31,408	28,267	18,845	9,423
Under the Present Law				
For 100 Corporations	445	445	445	445
For 200 Corporations	1,064	1,064	1,064	1,064
For 300 Corporations	2,311	2,311	2,311	2,311
For 400 Corporations	3,045	3,045	3,045	3,045
For 500 Corporations	3,851	3,851	3,851	3,851
For 600 Corporations	4,386	4,386	4,386	4,386
For 700 Corporations	4,944	4,944	4,944	4,944
For 856 Corporations	5,769	5,769	5,769	5,769
Difference between present law and Proposition II				
For 100 Corporations	4,098	3,644	2,281	918
For 200 Corporations	6,362	5,619	3,391	1,164
For 300 Corporations	11,169	9,820	5,776	1,733
For 400 Corporations	15,209	13,383	7,907	2,431
For 500 Corporations	17,673	15,520	9,063	2,606
For 600 Corporations	20,068	17,622	10,286	2,950
For 700 Corporations	22,057	19,358	11,257	3,156
For 856 Corporations	25,639	22,498	13,076	3,654

1/Calculations by BRIMMER & COMPANY from: 1) Sales data provided by the 856 corporations on Form 10-K filed with the Securities and Exchange Commission; and 2) Product Liability Insurance premium rates from the Insurance Study Final Report, Interagency Task Force on Product Liability.

2/The corporations were divided into groups of 100, each group containing companies of various sizes and manufacturing a variety of products.

3/Figures are cumulative.

TABLE 7. Potential Loss to the U.S. Treasury for Product Liability Insurance Coverage Under Severe Risk (Deductions for 5 Per Cent of Gross Receipts and Ordinary Risk (Based on 2 Per Cent of Gross Receipts) for 856 Corporations with Sales $100 Million and Over) 1/

Corporations 2/	Loss to Treasury (in millions of dollars) 3/			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self-insurance
Under Proposition II				
For 100 Corporations	2,179	1,961	1,308	654
For 200 Corporations	3,561	3,205	2,137	1,069
For 300 Corporations	6,466	5,819	3,880	1,940
For 400 Corporations	8,556	7,880	5,254	2,627
For 500 Corporations	10,124	9,291	6,195	3,097
For 600 Corporations	11,729	10,556	7,038	3,519
For 700 Corporations	12,951	11,656	7,771	3,886
For 856 Corporations	15,064	13,558	9,039	4,520
Under the Present Law				
For 100 Corporations	212	212	212	212
For 200 Corporations	508	508	508	508
For 300 Corporations	1,105	1,105	1,105	1,105
For 400 Corporations	1,456	1,456	1,456	1,456
For 500 Corporations	1,841	1,841	1,841	1,841
For 600 Corporations	2,096	2,096	2,096	2,096
For 700 Corporations	2,363	2,363	2,363	2,363
For 856 Corporations	2,757	2,757	2,757	2,757
Difference between present law and Proposition II				
For 100 Corporations	1,967	1,749	1,096	442
For 200 Corporations	3,053	2,697	1,629	561
For 300 Corporations	5,360	4,714	2,774	835
For 400 Corporations	7,299	6,424	3,797	1,171
For 500 Corporations	8,482	7,450	4,352	1,256
For 600 Corporations	9,632	8,459	4,940	1,422
For 700 Corporations	10,587	9,292	5,407	1,522
For 856 Corporations	12,307	10,801	6,282	1,763

1/Calculations by BRIMMER & COMPANY from deductions as reported--in Table 6, using a tax rate for each corporation of 20 per cent of the first $25,000; 22 per cent of the second $25,000; and 48 per cent of the balance.

2/The corporations were divided into groups of 100, each group containing companies of various sizes and manufacturing a variety of products.

3/Figures are cumulative.

Tables 8 and 9 provide estimates of the deductions and potential losses, respectively, to the Treasury if the 300 firms discussed above chose to self-insure under this proposition. If these firms chose to self-insure totally, the potential deductions could be as much as $4.0 billion. At 90 per cent, the figure is $3.5 billion; at 60 per cent, $2.1 billion, and at 30 per cent $647 million. The potential loss of Treasury revenue is $1.9 billion at 100 per cent self-insurance. At 90 per cent, it is $1.7 billion; at 60 per cent $1.0 billion, and at 30 per cent $314 million.

The potential loss to the U.S. Treasury from the industries represented by the 300-firm sample might be as much as $15.3 billion -- if the firms in those industries were to self-insure totally (Table 10). At 90 per cent, the figure is $13.7 billion; at 60 per cent it is $9.2 billion, and at 30 per cent it is $4.6 billion.

For all manufacturing industries combined, the potential loss is $23.2 billion -- for 100 per cent self-insurance. At 90 per cent, the potential loss is $20.1 billion; at 60 per cent it is $13.9 billion, and at 30 per cent it is $7.0 billion.

<u>Proposition III</u>: <u>Fair Market Value</u>

Under this proposition, taxpayers would be allowed annual tax deductions for contributions to a product liability reserve account or trust. However, such deductions would be limited to an amount equal to the "fair market value" of product liability insurance for such taxpayer.

TABLE 8. Potential Deductions for Product Liability Insurance Coverage Under Severe Risk (Deductions Based on 5 Per Cent of Gross Receipts) and Ordinary Risk (Based on 2 Per Cent of Gross Receipts) for a Random Sample of 300 Firms.) 1/

	Deductions (in millions of dollars)			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self insurance
Under Proposition II				
Industrial machinery	199	179	119	60
Grinding wheels	409	368	245	123
Ferrous castings	1,068	961	641	320
Industrial chemicals	640	576	384	192
Aircraft components	571	514	342	171
Auto components	361	325	216	108
Medical devices	510	459	306	153
Pharmaceuticals	419	377	251	126
Lawnmowers	361	325	216	108
Other	245	221	147	74
TOTAL	4,784	4,306	2,870	1,435
Under Present Law				
Industrial machinery	43	43	43	43
Grinding wheels	75	75	75	75
Ferrous castings	155	155	155	155
Industrial chemicals	114	114	114	114
Aircraft components	94	94	94	94
Auto components	64	64	64	64
Medical devices	90	90	90	90
Pharmaceuticals	73	73	73	73
Lawnmowers	65	65	65	65
Other	14	14	14	14
TOTAL	788	788	788	788
Difference between Present Law and Proposition				
Industrial machinery	156	136	76	17
Grinding wheels	334	293	170	46
Ferrous castings	913	806	486	165
Industrial chemicals	526	462	270	78
Aircraft components	477	420	249	77
Auto components	297	261	152	44
Medical devices	420	369	216	63
Pharmaceuticals	346	304	178	53
Lawnmowers	296	260	152	44
Other	231	207	133	60
TOTAL	3,996	3,518	2,082	647

1/ Calculations by BRIMMER & COMPANY from: 1) Sales figures in the 1978 Dun & Bradstreet Directory and 2) Product Liability Insurance Prorates from the Insurance Study Final Report, Interagency Task Force on Product Liability.

TABLE 9. Potential Loss to the U.S. Treasury for Product Liability Insurance Coverage Under Severe Risk (Deductions Based on 5 Per Cent of Gross Receipts) and Ordinary Risk (Based on 2 Per Cent Gross Receipts) for a Random Sample of 300 Firms.) 1/

	Loss	(in millions of dollars)		
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self-insurance
Under Proposition II				
Industrial machinery	95	86	57	29
Grinding wheels	196	176	118	59
Ferrous castings	512	461	307	154
Industrial chemicals	307	276	184	92
Aircraft components	273	246	164	82
Auto components	173	156	104	52
Medical devices	245	220	147	73
Pharmaceuticals	201	181	120	60
Lawnmowers	173	156	104	52
Other	117	105	70	35
TOTAL	2,292	2,063	1,375	688
Under Present Law				
Industrial machinery	20	20	20	20
Grinding wheels	36	36	36	36
Ferrous castings	74	74	74	74
Industrial chemicals	54	54	54	54
Aircraft components	45	45	45	45
Auto components	31	31	31	31
Medical devices	43	43	43	43
Pharmaceuticals	34	34	34	34
Lawnmowers	31	31	31	31
Other	6	6	6	6
TOTAL	374	374	374	374
Difference between Present Law and Proposition II				
Industrial machinery	75	65	37	8
Grinding wheels	160	141	82	23
Ferrous castings	438	387	233	80
Industrial chemicals	253	222	130	38
Aircraft components	229	201	119	37
Auto components	142	126	73	21
Medical devices	202	177	104	31
Pharmaceuticals	166	146	86	26
Lawnmowers	142	125	73	21
Other	111	99	64	29
TOTAL	1,913	1,689	1,001	314

1/Calculations by BRIMMER & COMPANY from deductions as reported in Table 8 using a tax rate for each firm, 20 per cent of the first $25,000; 22 per cent of the second $25,000; and 48 per cent of the balance.

TABLE 10. Potential Loss to U.S. Treasury for Product Liability Coverage Under Ordinary Risk (Deductions Based on 5 Per Cent of Gross Receipts) and Ordinary Risk (Based on 2 Per Cent of Gross Receipts) for Industries Represented by 300 firms.) 1/

	Loss to Treasury (in millions of dollars)			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self-insurance
(a) Under Proposition II 2/ (Selected Industries guide)				
Industrial machinery	1,130	1,017	678	339
Grinding wheels	*	*	*	*
Ferrous castings	1,054	949	632	316
Industrial chemicals	815	733	489	245
Aircraft components	168	151	101	50
Medical devices	161	145	97	48
Pharmaceuticals	264	238	158	79
Lawnmowers	*	*	*	*
Other	9,754	8,779	5,852	2,926
TOTAL	13,266	13,739	9,160	4,580
(b) Manufacturers' Sales Guide) 3/				
Industrial machinery	2,000	1,800	1,200	600
Grinding wheels	*	*	*	*
Ferrous castings	697	627	418	209
Industrial chemicals	1,995	1,796	1,197	599
Aircraft components	3,163	2,847	1,898	949
Auto components	**	**	**	**
Medical devices	*	*	*	*
Pharmaceuticals	*	*	*	*
Lawnmowers	*	*	*	*
Other	15,347	13,812	9,208	4,604
TOTAL	23,202	20,882	13,921	6,961

*Total industry figures not available hence included in "other" category.
**Estimate combined with "auto components" below, representing the transportation equipment industry.

1/Calculations by BRIMMER & COMPANY from the losses as reported in Table 9 showing loss to U.S. Treasury for a random sample of 300 firms.

2/Estimated loss based on "value of shipments" by selected manufacturing industries in 1977, reported in U.S. Department of Commerce, U.S. Industrial Outlook, 1978, Appendix A, pp. 465-468.

3/Estimated loss based on "Manufacturers' Sales (shipments)" by major industry group in 1976, reported in U.S. Department of Commerce, Survey of Current Business, April, 1978, pp. S-5 and S-6.

In developing this estimate of a potential loss to the Treasury, the "fair market value" of product liability insurance had to be determined. At least one of the bills now being considered in Congress provides that the Secretary of the Treasury in promulgating regulations shall take into account the rates charged and quoted by liability insurance companies to the taxpayer and to firms comparable to the taxpayer, the amount of insurance coverage customarily maintained by the taxpayer and such firms, and the frequency and severity of product liability claims (including administrative and investigating expenses) made against the taxpayer and firms comparable to the taxpayer. Moreover, when those factors are taken into consideration, there must remain no assurance that present premium rates represent what would be the fair market value of product liability insurance -- were this proposition to be enacted into law.

If Proposition III were adopted, the following set of circumstances may evolve:

> More large corporations may be inclined to self-insure -- and for a larger percentage of their product liability coverage.
>
> If the large corporations no longer insure with the conventional insurance companies at the present level, those insurance companies may be inclined to raise their premium rates.

In preparing the estimate presented here, it was assumed initially that -- if Proposition III were enacted -- some increase would occur in the product liability premium rate charged by insurance companies. This rate was taken as the "fair market value"

of the coverage. The increase might occur because more large corporations may be inclined to self-insure. The actual magnitude of such an increase is impossible to predict. For purposes of this report, a 41 per cent increase in the present premium rate was used in developing the fair market value under Proposition III.

This estimate was developed using the Interagency Task Force on Product Liability information collected by Gordon Associates on the Estimated Average Product Liability Cost per $1,000 in 1976. The 41 per cent was derived by BRIMMER & COMPANY as follows:

> In 1976, 38 companies with sales less than $2.5 million reported the estimated product liability cost to be $5.32; 64 companies with sales between $2.5 million to $100 million reported their product liability cost to be $3.23. Since the estimate for Proposition II is based on the assumption that the large corporations will self-insure, their premium rate was not included in the calculation. The weighted average for companies with sales below $100 million is $3.97 per $1,000 in total sales. The rate for firms of all sizes was $2.81 per $1,000. Assuming the rate would be increased to the $3.97 per $1,000, the overall percentage increase would be 41 per cent (.397 - .281/.281).

Table 11 provides the estimates of the potential deductions for the 856 corporations if they take advantage of the tax incentives to self-insure embodied in Proposition III. Table 11 also provides information on the difference in maximum deduction allowable as between Proposition III and the present law. Table 12 presents estimates of the potential loss to the Treasury were the deductions shown in Table 11 to be taken.

TABLE 11. Potential Deductions for Product Liability Insurance Where Deductions are Based on Fair Market Value of Coverage for 856 Corporations with Sales $100 Million and Over. 1/

Corporations 2/	(In millions of dollars) 3/			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self-insurance
Under Proposition				
For 100 Corporations	1,254	1,128	752	376
For 200 Corporations	2,111	1,900	1,266	633
For 300 Corporations	3,970	3,573	2,381	1,191
For 400 Corporations	5,018	4,517	3,010	1,506
For 500 Corporations	6,092	5,483	3,654	1,828
For 600 Corporations	6,827	6,145	4,095	2,049
For 700 Corporations	7,652	6,888	4,590	2,297
For 856 Corporations	8,793	7,915	5,276	2,640
Under the Present Law				
For 100 Corporations	445	445	445	445
For 200 Corporations	1,064	1,064	1,064	1,064
For 300 Corporations	2,311	2,311	2,311	2,311
For 400 Corporations	3,045	3,045	3,045	3,045
For 500 Corporations	3,851	3,851	3,851	3,851
For 600 Corporations	4,386	4,386	4,386	4,386
For 700 Corporations	4,944	4,944	4,944	4,944
For 856 Corporations	5,769	5,769	5,769	5,769
Difference between present law and Proposition				
For 100 Corporations	809	684	308	-69
For 200 Corporations	1,047	837	203	-430
For 300 Corporations	1,658	1,262	71	-1,120
For 400 Corporations	1,972	1,472	-34	-1,539
For 500 Corporations	2,241	1,632	-197	-2,023
For 600 Corporations	2,441	1,759	-291	-2,337
For 700 Corporations	2,708	1,944	-354	-2,647
For 856 Corporations	3,024	2,146	-493	-3,129

1/Calculations by BRIMMER & COMPANY from: 1) Sales data provided by the 856 corporations on Form 10-K filed with the Securites and Exchange Commission; and 2) Product Liability Insurance premium rates from the Insurance Study Final Report, Interagency Task Force on Product Liability.

2/The corporations were divided into groups of 100, each group containing companies of various sizes and manufacturing a variety of products.

3/Figures are cumulative.

TABLE 12. Potential Loss to the U.S. Treasury for Product Liability Insurance Where Deductions are Based on Fair Market Value of Coverage for 856 Corporations with Sales of $100 Million and Over. 1/

Corporations 2/	Loss to Treasury (In millions of dollars) 3/ 100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self-insurance
Under Proposition III				
For 100 Corporations	600	540	360	180
For 200 Corporations	1,010	909	606	303
For 300 Corporations	1,901	1,711	1,141	570
For 400 Corporations	2,403	2,163	1,442	721
For 500 Corporations	2,917	2,626	1,750	875
For 600 Corporations	3,269	2,942	1,961	980
For 700 Corporations	3,664	3,297	2,198	1,098
For 856 Corporations	4,209	3,788	2,525	1,261
Under the Present Law				
For 100 Corporations	212	212	212	212
For 200 Corporations	508	508	508	508
For 300 Corporations	1,105	1,105	1,105	1,105
For 400 Corporations	1,456	1,456	1,456	1,456
For 500 Corporations	1,841	1,841	1,841	1,841
For 600 Corporations	2,096	2,096	2,096	2,096
For 700 Corporations	2,363	2,363	2,363	2,363
For 856 Corporations	2,757	2,757	2,757	2,757
Difference between present law and Proposition III				
For 100 Corporations	388	328	148	- 32
For 200 Corporations	502	401	99	- 205
For 300 Corporations	795	605	36	- 535
For 400 Corporations	946	705	- 14	- 735
For 500 Corporations	1,075	782	- 91	- 966
For 600 Corporations	1,171	843	- 135	- 1,115
For 700 Corporations	1,299	932	- 165	- 1,264
For 856 Corporations	1,452	1,031	- 232	- 1,496

1/Calculations by BRIMMER & COMPANY from deductions as reported--in Table 11 using a tax rate for each corporation of 20 per cent of the first $25,000; 22 per cent of the second $25,000; and 48 per cent of the balance.

2/The corporations were divided into groups of 100, each group containing companies of various sizes and manfacturing a variety of products.

3/Figures are cumulative.

Assuming full participation of the 856 corporations in the self-insurance program, the deductions which could be taken could amount to $8.8 billion -- or $3.0 billion more than under the present law. The loss to the United States Treasury could run as high as $4.2 billion, or an increase of $1.5 billion. Assuming 90 per cent participation of the 856 corporations, there would be a potential deduction of $7.9 billion and a loss to the U.S. Treasury of $3.8 billion -- an increase of $1.0 billion.

At 60 per cent and 30 per cent participation levels, there would be a decrease in deductions and no loss to the U.S. Treasury, assuming the corporations do not supplement their self-insurance with conventional coverage. Assuming 60 per cent participation, there would be a gain to the U.S. Treasury of $232 million; at 30 per cent participation, the gain would be $1.4 billion.

As mentioned above, fair market value as defined for purposes of this report represents a 41 per cent increase in the present premium rates. Thus, it is not surprising that there would be no loss to the Treasury under this assumption. When a comparison is made between 100 per cent coverage with conventional insurance companies and 30 per cent coverage under a self-insurance scheme -- with the rate increase of less than 50 per cent -- the results are advantageous to the Treasury.

Of course, it could be argued that the "fair market value" of insurance under Proposition III would be equivalent to the present premium rate. Were that to be the case, the loss to the Treasury might approximate $2.8 billion. This is the same as under the present law.

Tables 13 and 14, respectively, provide estimates on the deductions and potential losses to the Treasury if the members of the 300-firm sample choose to self-insure under Proposition III. The potential deductions could amount to $1.1 billion at 100 per cent participation. At 90 per cent, the figure is $1.0 billion; at 60 per cent $688 million, and at 30 per cent $344 million. Assuming full participation, the potential loss to the Treasury is $546 million -- $172 million more than under present law. At 90 per cent participation, the loss is $492 million, or an increase of $118 million.

At 60 per cent participation, the Treasury might gain $44 million under Proposition III. At 30 per cent participation, the gain might climb to $210 million.

As shown in Table 15, using the 300-firm sample as a benchmark, the selected industries which they represent might generate a loss to the Treasury of $1.4 billion -- at 100 per cent participation. At 90 per cent, the figure is $1.3 billion; at 60 per cent it is $835 million; at 30 per cent it is $418 million. For all manufacturing sectors combined, the loss to the Treasury is estimated at $2.1 billion -- assuming 100 per cent participation. At 90 per cent, the loss is $1.9 billion; at 60 per cent it is $1.3 billion, and at 30 per cent it is $639 million.

Proposition IV: Fair Market Value Plus Reserve and Investment Income

Under this proposition, taxpayers would be allowed annual tax deductions for contributions to a product liability reserve

TABLE 13. Potential Deductions for Product Liability Insurance Where Deductions are Based on Fair Market Value of Coverage for a Random Sample of 300 Firms. 1/

	Deductions (in millions of dollars)			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self insurance
Under Proposition III				
Industrial machinery	61	55	37	19
Grinding wheels	104	94	62	31
Ferrous castings	223	200	134	67
Industrial chemicals	178	160	107	53
Aircraft components	131	118	79	39
Auto components	97	87	58	29
Medical devices	129	116	77	39
Pharmaceuticals	100	90	60	30
Lawnmowers	97	87	58	29
Other	27	25	16	8
TOTAL	1,147	1,032	688	344
Under Present Law				
Industrial machinery	43	43	43	43
Grinding wheels	75	75	75	75
Ferrous castings	156	156	156	156
Industrial chemicals	114	114	114	114
Aircraft components	94	94	94	94
Auto components	64	64	64	64
Medical devices	90	90	90	90
Pharmaceuticals	73	73	73	73
Lawnmowers	65	65	65	65
Other	14	14	14	14
TOTAL	788	788	788	788
Difference between Present Law and Proposition III				
Industrial machinery	18	12	- 6	- 25
Grinding wheels	29	19	- 13	- 44
Ferrous castings	68	45	- 21	- 88
Industrial chemicals	64	46	- 8	- 61
Aircraft components	37	24	- 15	- 55
Auto components	32	23	- 6	- 35
Medical devices	39	26	- 13	- 51
Pharmaceuticals	27	17	- 13	- 43
Lawnmowers	32	22	- 7	- 36
Other	13	10	2	- 6
TOTAL	359	244	-100	-444

1/ Calculations by BRIMMER & COMPANY from: 1) Sales figures in the 1978 Dun & Bradstreet Directory and 2) Product Liability Insurance Premium rates from the Insurance Study Final Report, Interagency Task Force on Product Liability.

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TABLE 14. Potential Loss to U.S. Treasury for Product Liability Insurance Where Deductions are Based on Fair Market Value of Coverage for a Random Sample of 300 Firms. 1/

	Loss (in millions of dollars)			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self insurance
Under Proposition III				
Industrial machinery	29	26	18	9
Grinding wheels	50	45	30	15
Ferrous castings	106	96	64	32
Industrial chemicals	85	77	51	25
Aircraft components	63	56	38	19
Auto components	46	41	28	14
Medical devices	61	55	37	18
Pharmaceuticals	48	43	29	14
Lawnmowers	46	42	28	14
Other	12	11	7	4
TOTAL	546	492	330	164
Under Present Law				
Industrial machinery	20	20	20	20
Grinding wheels	36	36	36	36
Ferrous castings	74	74	74	74
Industrial chemicals	54	54	54	54
Aircraft components	45	45	45	45
Auto components	31	31	31	31
Medical devices	43	43	43	43
Pharmaceuticals	34	34	34	34
Lawnmowers	31	31	31	31
Other	6	6	6	6
TOTAL	374	374	374	374
Difference between Present Law and Proposition III				
Industrial machinery	9	6	- 2	- 11
Grinding wheels	14	9	- 6	21
Ferrous castings	32	22	-10	42
Industrial chemicals	31	22	- 3	- 29
Aircraft components	18	12	- 7	- 26
Auto components	15	11	- 3	- 17
Medical devices	18	12	- 5	- 25
Pharmaceuticals	13	8	- 6	- 20
Lawnmowers	15	11	- 3	- 17
Other	6	5	1	- 2
TOTAL	172	118	-44	-210

1/Calculations by BRIMMER & COMPANY from deductions as reported in Table 13 using a tax rate for each firm of 20 per cent of the first $25,000; 22 per cent of the second $25,000; and 48 per cent of the balance.

TABLE 15. Potential Loss to U.S. Treasury for Product Liability Insurance Where Deductions are Based on Fair Market Value of Coverage in Industries Represented by 300 Firms. 1/

	Loss to Treasury (in millions of dollars)			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self-insurance
(a) 2/ Under Proposition III (Selected industries guide)				
Inustrial machinery	136	122	24	41
Grinding wheels	*	*	*	*
Ferrous castings	77	69	46	23
Industrial chemicals	100	90	60	30
Aircraft components	13	12	8	4
Auto components	203	183	122	61
Medical devices	15	14	9	5
Pharmaceuticals	21	19	13	6
Lawnmowers	*	*	*	*
Other	827	744	496	248
TOTAL	1,392	1,253	835	418
(b) 3/ (Manufacturers' Sales Guide)				
Industrial machinery	240	216	144	72
Grinding wheels	*	*	*	*
Ferrous castings	51	46	31	15
Industrial chemicals	244	220	146	73
Aircraft components	**	**	**	**
Auto components	281	253	169	84
Medical devices	*	*	*	*
Pharmaceuticals	*	*	*	*
Lawnmowers	*	*	*	*
Other	1,317	1,185	790	395
TOTAL	2,133	1,920	1,280	639

*Total industry figures not available, hence included in "other" category.
**Estimate combined with "auto components" below, representing the transportation equipment industry.

1/Calculations by BRIMMER & COMPANY from the losses as reported in Table 14 showing loss to U.S. Treasury for a random sample of 300 firms.

2/Estimated loss based on "value of shipments" by selected manufacturing industries in 1977, reported in U.S. Department of Commerce, U.S. Industrial Outlook, 1978, Appendix A, pp. 465-468.

3/Estimated loss based on "Manufacturers' Sales (shipments)" by major industry group in 1976, reported in U.S. Department of Commerce, Survey of Current Business, April, 1978, pp. S-5 and S-6.

account or trust. Again, however, deductions for such contribution could not exceed an amount equal to the fair market value of the product liability insurance for such taxpayer. In addition, taxpayers would be allowed deductions for accumulated earnings in the product liability reserve account. Further deductions would be allowed for income of the trust which would not be used for any purpose other than the payment of product liability claims.

In developing this estimate, the "fair market value" was calculated as discussed above under Proposition III. This figure was then used to determine the level of tax-exempt contribution to the product liability reserve account.

As is the case in at least one of the other alternatives under consideration, Proposition IV contemplates deductions for the accumulated earnings in the trust. There is some debate as to whether this represents an actual loss to the Treasury. For example, it is argued that the type of corporation represented by the 856 companies whose experiences are examined here would not accumulate earnings in excess of the amounts necessary to meet the reasonably anticipated needs of the business of the taxpayer without some exemption in the law. Here, however, the initial estimates are provided assuming deductions and loss to Treasury from accumulated earnings.

In developing the estimates, the following steps were taken:

(1) A two-year contribution to the reserve account was assumed, using 1976 and 1977 sales figures as guides.

(2) From the amounts paid into the trust for each year, it was assumed that 36 per cent remained at the end

of the second year and would be subjected to the accumulated earnings tax deduction.8/

The loss of the U.S. Treasury from deductions for accumulated earnings is 27½ per cent of the first $100,000 and 38½ per cent of the remainder of the accumulated taxable income.

The estimate of the income from the trust assumed investment in time deposits, U.S. Government securities, and state and local obligations. Since at least one of the proposed bills restricts investment of assets to these low risk and highly liquid assets, they were used in the development of the estimate reported here. The yield on these investments was projected at 6.60 per cent.9/

Table 16 shows the estimates of the potential deductions for the 856 corporations -- if they take advantage of the tax incentives provided by Proposition IV. Table 16 also provides information on the difference in maximum deductions allowable as between Proposition IV and the present law. Table 17 shows estimates of the potential loss to the Treasury were the deductions shown in Table 16 to be taken. The deductions in Table 16 and the loss to the Treasury in Table 17 are estimated assuming four different levels of participation in the self-insurance activity.

8/ McKinsey & Company, Inc., developed an estimate for the Interagency Task Force on Product Liability of the allocation of the product liability premium dollar. The elements of the amounts remaining in the reserve account are: case reserves (15 per cent), incurred-but-not-reported reserves (7 per cent); loss adjustment expenses for case reserves (6 per cent) loss adjustment expenses for incurred-but-not-reported reserves (3 per cent); anticipated profit (5 per cent).

9/ The 6.60 per cent yield was calculated by determining the weighted average of the 1977 yield on nonfinancial corporations assets. Total time deposits were $28.1 billion with a 6.63 per cent yield; U.S. Government securities were $19.4 billion with a 6.78 per cent yield; state and local obligations of $3.5 billion at a 5.56 per cent yield. Source: Economic Report of the President, 1978.

Based on Fair Market Value of Coverage Plus Reserve and Investment Income
for 857 Corporations with Sales $100 Million and Over. 1/

Corporations 2/	Deductions (in millions of dollars) 100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self-insurance
Under Proposition IV				
For 100 Corporations	3,942	3,548	2,365	1,183
For 200 Corporations	5,412	4,871	3,247	1,624
For 300 Corporations	8,662	7,796	5,197	2,599
For 400 Corporations	10,450	9,405	6,270	3,135
For 500 Corporations	12,358	11,122	7,415	3,707
For 600 Corporations	13,617	12,255	5,170	4,085
For 700 Corporations	14,692	13,222	8,815	4,407
For 856 Corporations	16,638	14,974	9,982	4,991
Under the Present Law				
For 100 Corporations	445	445	445	445
For 200 Corporations	1,064	1,064	1,064	1,064
For 300 Corporations	2,311	2,311	2,311	2,311
For 400 Corporations	3,045	3,045	3,045	3,045
For 500 Corporations	3,851	3,851	3,851	3,851
For 600 Corporations	4,386	4,386	4,386	4,386
For 700 Corporations	4,944	4,944	4,944	4,944
For 856 Corporations	5,769	5,789	5,769	5,769
Difference between present law and Proposition IV				
For 100 Corporations	3,498	3,103	1,921	738
For 200 Corporations	4,349	3,807	2,184	560
For 300 Corporations	6,352	5,485	2,887	288
For 400 Corporations	7,406	6,361	3,226	91
For 500 Corporations	8,508	7,272	3,565	- 143
For 600 Corporations	9,232	7,870	3,785	- 300
For 700 Corporations	9,749	8,279	3,872	- 535
For 856 Corporations	10,866	9,202	4,210	- 781

1/Calculations by BRIMMER & COMPANY from: 1) Sales data provided by the 856 corporations on Form 10-K filed with the Securites and Exchange Commission; and 2) Product Liability Insurance premium rates from the Insurance Study Final Report, Interagency Task Force on Product Liability.
2/The corporations were divided into groups of 100, each group containing companies of various sizes and manufacturing a variety of products.
3/Figures are cumulative.

TABLE 17. Potential Loss to the U.S. Treasury for Product Liability Insurance Where Deductions are Based on Fair Market Value of Coverage Plus Reserve and Investment Income for 856 Corporations with Sales $100 Million and Over. 1/

Corporations 2/	Loss to Treasury 100 per cent self-insurance	(In millions of dollars) 3/ 90 per cent self-insurance	60 per cent self-insurance	30 per cent self-insurance
Under Proposition IV				
For 100 Corporations	1,650	1,485	990	495
For 200 Corporations	2,290	2,061	1,374	687
For 300 Corporations	3,724	3,351	2,234	1,117
For 400 Corporations	4,492	4,042	2,698	1,347
For 500 Corporations	5,331	4,797	3,198	1,599
For 600 Corporations	5,887	5,298	3,532	1,766
For 700 Corporations	6,378	5,740	3,827	1,913
For 856 Corporations	7,237	6,513	4,343	2,170
Under the Present Law				
For 100 Corporations	212	212	212	212
For 200 Corporations	508	508	508	508
For 300 Corporations	1,105	1,105	1,105	1,105
For 400 Corporations	1,456	1,456	1,456	1,456
For 500 Corporations	1,841	1,841	1,841	1,841
For 600 Corporations	2,096	2,096	2,096	2,096
For 700 Corporations	2,363	2,363	2,363	2,363
For 856 Corporations	2,757	2,757	2,757	2,757
Difference between present law and Proposition IV				
For 100 Corporations	1,438	1,273	778	283
For 200 Corporations	1,782	1,553	866	179
For 300 Corporations	2,618	2,246	1,129	12
For 400 Corporations	3,035	2,586	1,239	- 109
For 500 Corporations	3,488	2,956	1,357	- 243
For 600 Corporations	3,789	3,201	1,435	- 332
For 700 Corporations	4,014	3,377	1,463	- 451
For 856 Corporations	4,480	3,756	1,586	- 587

1/Calculations by BRIMMER & COMPANY from deductions as reported--in Table16, using a tax rate for each corporation of 20 per cent of the first $25,000; 22 per cent of the second $25,000; and 48 per cent of the balance. Tax on reserve was 27½ per cent on first $100,000 and 38½ per cent on rest

2/The corporations were divided into groups of 100, each group containing companies of various sizes and manufacturing a variety of products.

3/Figures are cumulative.

required for business purposes without some exemption in the law. Initially, the estimates are provided here assumed deductions and loss to Treasury from accumulated earnings.

In developing these estimates, the following steps were taken:

(1) A two-year contribution to the reserve account was assumed, using 1976 and 1977 sales figures as guides.

(2) From the amounts paid into the trust for each year, it was assumed that 36 per cent remained at the end of the second year and would be subjected to the accumulated earnings tax deduction.10/

The loss to the U.S. Treasury from deductions for accumulated earnings is 27½ per cent of the first $100,000 and 38½ per cent of the remainder of the accumulated taxable income.

The estimate of the income from the trust assumed investment in time deposits, U.S. Government securities and state and local obligations. Since at least one of the proposed bills restricts investment of assets to these low risk and highly liquid assets, they were used in the development of the estimate here. The yield on these investments was projected at 6.60 per cent.11/

The limitation on the amount deductible under this proposition indicates that it is not designed for the large corporations -- many of which presently pay premiums running into millions of dollars annually. The estimates under Proposition V assume that the large corporations will take advantage of the tax incentive and place

10/ See footnote above for a description of the elements in the reserve account.

11/ See footnote above for a description of the technique used to estimate the yield.

Under this proposition and assuming full participation of the 856 corporations, the potential deduction is $16.6 billion. This figure is $10.9 billion higher than under present law. Under the present Internal Revenue Code, the potential loss to the Treasury if those 856 corporations were insured by conventional insurance companies are estimated at $2.8 billion. The loss under this proposition was estimated at $7.2 billion, or $4.5 billion more. With 90 per cent participation and no supplement with conventional insurance, deductions could run to $15.0 billion, an increase of $9.2 billion. The potential loss to the U.S. Treasury would be $6.5 billion, an increase of $3.8 billion. At 60 per cent, the deduction would be $10.0 billion, and the potential loss would approximate $4.3 billion. Assuming 30 per cent participation by the corporations, leaving the corporation bare of 70 per cent coverage, does not result in a loss to the Treasury. Rather a gain of $587 million is estimated. It is most unlikely that any of these firms would insure only at the 30 per cent level.

Tables 18 and 19, respectively, provide estimates of the deductions and potential losses to the Treasury if 300 firms chose to self-insure under Proposition IV. If these firms decided to self-insure totally, the potential deductions would amount to $2.0 illion, and the loss to the Treasury could be $860 million -- or an additional $486 million. If all the firms in the industries represented by these 300 firms chose to self-insure under this proposition, the loss to Treasury could be up to $3.9 billion, as shown in Table 20, panel(a). The potential losses to the U.S. Treasury if all manufacturing

TABLE 18. Potential Deductions for Product Liability Insurance Where Deductions are Based on Fair Market Value of Coverage Plus Reserve and Investment Income for a Random Sample of 300 Firms. 1/

	Deductions (in millions of dollars)			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self-insurance
Under Proposition IV				
Industrial machinery	109	98	65	33
Grinding wheels	184	166	111	55
Ferrous castings	390	351	234	117
Industrial chemicals	275	247	165	82
Aircraft components	232	209	139	71
Auto components	172	154	103	51
Medical devices	228	205	137	68
Pharmaceuticals	177	159	106	53
Lawnmowers	171	154	103	51
Other	47	43	28	14
TOTAL	1,985	1,786	1,191	595
Under Present Law				
Industrial machinery	43	43	43	43
Grinding wheels	75	75	75	75
Ferrous castings	156	156	156	156
Industrial chemicals	114	114	114	114
Aircraft components	94	94	94	94
Auto components	64	64	64	64
Medical devices	90	90	90	90
Pharmaceuticals	73	73	73	73
Lawnmowers	65	65	65	65
Other	14	14	14	14
TOTAL	788	788	788	788
Difference between Present Law and Proposition IV				
Industrial machinery	65	55	22	- 11
Grinding wheels	109	91	36	- 20
Ferrous castings	236	196	79	- 38
Industrial chemicals	160	133	51	- 32
Aircraft components	138	115	45	- 24
Auto components	107	90	38	- 13
Medical devices	138	115	47	- 22
Pharmaceuticals	103	86	33	- 20
Lawnmowers	107	89	38	- 13
Other	33	28	14	0
TOTAL	1,197	998	403	-193

1/Calculations by BRIMMER & COMPANY from: 1) Sales figures in the 1978 Dun & Bradstreet Directory and 2) Product Liability Insurance Premium rates from the Insurance Study Final Report, Interagency Task Force on Product Liability.

TABLE 19. Potential Loss to U.S. Treasury for Product Liability Insurance Where Deductions are Based on Fair Market Value of Coverage Plus Reserve and Investment Income for a Random Sample of 300 Firms. 1/

	Loss (in millions of dollars)			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent sel. insurance
Under Proposition IV				
Industrial machinery	50	45	30	15
Grinding wheels	79	71	47	24
Ferrous castings	170	153	102	51
Industrial chemicals	120	108	72	36
Aircraft components	100	90	60	30
Auto components	73	66	44	22
Medical devices	98	88	59	29
Pharmaceuticals	78	71	47	23
Lawnmowers	73	66	44	22
Other	19	17	11	6
TOTAL	860	775	516	258
Under Present Law				
Industrial machinery	20	20	20	20
Grinding wheels	36	36	36	36
Ferrous castings	74	74	74	74
Industrial chemicals	54	54	54	54
Aircraft components	45	45	45	45
Auto components	31	31	31	31
Medical devices	43	43	43	43
Pharmaceuticals	34	34	34	34
Lawnmowers	31	31	31	31
Other	6	6	6	6
TOTAL	374	374	374	374
Difference between Present Law and Proposition IV				
Industrial machinery	29	26	10	- 5
Grinding wheels	43	35	11	- 12
Ferrous castings	96	79	28	- 23
Industrial chemicals	66	54	18	- 18
Aircraft components	55	45	15	- 15
Auto components	43	35	13	- 9
Medical devices	55	45	16	- 14
Pharmaceuticals	44	36	13	- 10
Lawnmowers	42	35	13	- 9
Other	13	11	5	- 1
TOTAL	486	401	142	-116

1/Calculations by BRIMMER & COMPANY from deductions as reported in Table 18, using a tax rate for each firm of 20 per cent of the first $25,000; 22 per cent of the second $25,000 and 48 per cent of the balance. Tax on the reserve was 27½ per cent on first $100,000 and 38½ per cent on the remainder.

TABLE 20. Potential Loss to U.S. Treasury for Product Liability Insurance Where Deductions are Based on Fair Market Value of Coverage Plus Reserve and Investment Income in Industries Represented by 300 Firms. 1/

	LOSS (in millions of dollars)			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self-insurance
(a) Under Proposition IV 2/ (Selected industries guide)				
Industrial machinery	437	393	262	131
Grinding wheels	*	*	*	*
Ferrous castings	231	208	139	69
Industrial chemicals	212	191	127	64
Aircraft components	40	36	24	12
Auto components	581	523	349	174
Medical devices	44	40	26	13
Pharmaceuticals	70	63	42	21
Lawnmowers	*	*	*	*
Other	2,314	2,083	1,388	694
TOTAL	3,929	3,536	2,357	1,179
(b) (Manufacturers' sales guide) 3/				
Industrial machinery	773	696	464	232
Grinding wheels	*	*	*	*
Ferrous castings	153	138	92	46
Industrial chemicals	520	468	312	156
Aircraft components	**	**	**	**
Auto components	835	752	501	251
Medical devices	*	*	*	*
Pharmaceuticals	*	*	*	*
Lawnmowers	*	*	*	*
Other	3,871	3,484	2,323	1,161
TOTAL	6,152	5,538	3,692	1,846

* Total industry figures not available, hence included in "other" category.
** Estimate combined with "auto components" below, representing the transportation equipment industry.

1/ Calculations by BRIMMER & COMPANY from the losses as reported in Table 19 showing loss to U.S. Treasury for a random sample of 300 firms.

2/ Estimated loss based on "value of shipments" by selected manufacturing industries in 1977, reported in U.S. Department of Commerce, U.S. Industrial Outlook, 1978, Appendix A, pp. 465-468.

3/ Estimated loss based on "Manufacturers' Sales (shipments)" by major industry group in 1976, reported in U.S. Department of Commerce, Survey of Current Business, April, 1978, pp. S-5 and S-6.

industries chose to self-insure under Proposition IV could amount to $6.2 billion.

Proposition V: Dollar Limitation vs. Severity of Risk Plus Reserve and Investment Income

Under this proposition, taxpayers would be allowed annual tax deductions for either contributions to a product liability loss reserve account or amounts paid to a captive insurer. In both instances, the amount eligible for deduction is not to exceed the lesser of: (a) 5 per cent of the gross receipts for the manufacture, importation, distribution, lease or sale of a product having a severe product liability problem; and 2 per cent of such receipts for products not having a severe product liability problem; OR (b) $100,000 for severe product liability insurance problems and $25,000 for all others. In addition, taxpayers would be allowed deductions for accumulated earnings in the product liability reserve account. Further deductions would be allowed for income of the trust which would not be used for any purpose other than the payment of product liability claims.

In at least one of the self-insurance proposals advanced, a taxpayer qualifies as having a severe product liability problem if (for a taxable year) either (a) the taxpayer was unable to obtain a premium quotation for product liability insurance, with coverage of up to $1,000,000, from any insurer other than a captive insurer; or (b) the lowest insurance premium quotation with coverage up to $1,000,000 obtained by the taxpayer was equal to more than 3.0 per cent of the gross receipts of the taxpayer for such taxable year.

As explained above, this study did not involve a canvass of the corporations included in the estimate. Thus, it was not possible to determine which corporations qualify as having a severe product liability insurance problem as defined here. Consequently, in developing the estimate, the following approach was taken: a product line was classified as posing a severe product liability problem if it were so categorized by the Interagency Task Force. For the 856 large corporations, the assumption was that the lesser of the amount eligible for deduction would be $100,000 rather than 5 per cent of gross receipts. For products not having a severe product liability problem, the assumption was that the lesser of the amount eligible for deduction was $25,000 rather than 2 per cent of gross receipts. For the 300-firm sample, $100,000 and $25,000 were used because the sales figures in the data source (Dun and Bradstreet Million Dollar Directory) were not broken down by product line. For the 300 firms, if the enterprise manufactured any one product identified by the Interagency Task Force as having a severe product liability problem, the $100,000 figure was employed.

As is the case in at least one of the proposals under consideration, Proposition V contemplates deductions for the accumulated earnings in the reserve account. There is some debate as to whether this represents an actual loss to the Treasury. It is argued that the type of corporations represented by the 856 firms studied here would not accumulate earnings in excess of the amounts

$100,000 <u>or</u> $25,000 in a loss reserve account. This would be in addition to retaining their present coverage with conventional insurance companies. So, the deduction under this proposition is calculated by adding the following to the amount obtained by application of the present premium rate:

(a) $100,000 <u>or</u> $25,000, depending on whether the corporations manufactures products with severe product liability problems;

plus

(b) the accumulated earnings in the loss reserve account -- which would be either $72,000 or $18,000 ($100,000 x 2 years x 36 per cent, or $25,000 x 2 years x 36 per cent);

plus

(c) the investment income from the reserve account, which would be $4,752 or $1,188 ($72,000 x 6.60 per cent or $18,000 x 6.60 per cent).

Table 21 shows the estimates of the potential deductions for the 856 corporations -- if they take advantage of the tax incentives provided by Proposition V. Table 21 also contains information on the difference in maximum deductions allowable as between Proposition V and the present law. Table 22 presents estimates of the potential loss to the Treasury were the deductions shown in Table 21 to be taken. The deductions and loss to Treasury were calculated for four different levels of participation in the self-insurance activity.

Assuming full participation by the 856 companies, potential deductions might total $5.9 billion under Proposition V -- an increase of $106 million compared with the present law. The amount of deductions eases off only slightly as the level of participation decreases.

TABLE 21. Potential Deductions for Product Liability Insurance Where Deductions are Based on Dollar Limitations vs. Severity of Risk Plus Reserve and Investment Income for 856 Corporations with Sales of $100 Million and Over. 1/

Corporations 2/	Deductions 100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	(In millions of dollars) 3/ 30 per cent self-insurance
Under Proposition V				
For 100 Corporations	456	455	452	448
For 200 Corporations	1,088	1,086	1,076	1,071
For 300 Corporations	2,350	2,346	2,334	2,323
For 400 Corporations	3,097	3,092	3,076	3,061
For 500 Corporations	3,915	3,909	3,889	3,870
For 600 Corporations	4,462	4,454	4,432	4,409
For 700 Corporations	5,031	5,022	4,996	4,970
For 856 Corporations	5,875	5,864	5,833	5,801
Under the Present Law				
For 100 Corporations	445	445	445	445
For 200 Corporations	1,064	1,064	1,064	1,064
For 300 Corporations	2,311	2,311	2,311	2,311
For 400 Corporations	3,045	3,045	3,045	3,045
For 500 Corporations	3,851	3,851	3,851	3,851
For 600 Corporations	4,386	4,386	4,386	4,386
For 700 Corporations	4,944	4,944	4,944	4,944
For 856 Corporations	5,769	5,769	5,769	5,769
Difference between present law and Proposition				
For 100 Corporations	11	10	7	3
For 200 Corporations	24	22	14	7
For 300 Corporations	39	35	23	12
For 400 Corporations	52	47	31	16
For 500 Corporations	64	58	38	19
For 600 Corporations	76	68	46	23
For 700 Corporations	87	78	52	26
For 856 Corporations	106	95	64	32

1/Calculations by BRIMMER & COMPANY from: 1) Sales data provided by 856 corporations on Form 10-K filed with the Securities and Exchange Commission, and 2) Product Liability Insurance Premium rates from the Insurance Study Final Report, Interagency Task Force on Product Liability.
2/The corporations were divided into groups of 100, each group containing companies of various sizes and manufacturing a variety of products.
3/Figures are cumulative.

35-992 O - 79 - 20

TABLE 22. Potential Loss to U.S. Treasury for Product Liability Insurance Where Deductions are Based on Dollar Limitations vs. Severity of Risk Plus Reserve and Investment Income for 856 Corporations with Sales of $100 Million or Over. 1/

Corporations 2/	Loss To Treasury 100 per cent self-insurance	(In millions of dollars) 3/ 90 per cent self-insurance	60 per cent self-insurance	30 per cent self-insurance
Under Proposition V				
For 100 Corporations	215	215	214	211
For 200 Corporations	516	515	511	510
For 300 Corporations	1,119	1,118	1,111	1,109
For 400 Corporations	1,474	1,472	1,467	1,461
For 500 Corporations	1,864	1,862	1,855	1,848
For 600 Corporations	2,124	2,121	2,111	2,104
For 700 Corporations	2,395	2,392	2,382	2,373
For 856 Corporations	2,797	2,793	2,781	2,769
Under the Present Law				
For 100 Corporations	212	212	212	212
For 200 Corporations	508	508	508	508
For 300 Corporations	1,105	1,105	1,105	1,105
For 400 Corporations	1,456	1,456	1,456	1,456
For 500 Corporations	1,841	1,841	1,841	1,841
For 600 Corporations	2,096	2,096	2,096	2,096
For 700 Corporations	2,363	2,323	2,323	2,232
For 856 Corporations	2,757	2,757	2,757	2,757
Difference between present law and Proposition				
For 100 Corporations	3	3	2	1
For 200 Corporations	8	7	5	2
For 300 Corporations	14	13	8	4
For 400 Corporations	18	16	11	5
For 500 Corporations	23	21	14	7
For 600 Corporations	28	25	17	8
For 700 Corporations	32	29	19	10
For 856 Corporations	40	36	24	12

1/Calculations by BRIMMER & COMPANY from deductions as reported in Table 21, using a tax rate for each corporation of 20 per cent of the first $25,000; 22 per cent of the second $25,000; and 48 per cent of the balance.

2/The corporations were divided into groups of 100, with each group containing companies of various size and manufacturing a variety of products.

3/Figures are cumulative.

The potential loss to the U.S. Treasury is estimated at $2.8 billion -- assuming full participation in a self-insurance program. Here also the amount of loss eases off only slightly as the level of participation declines.

Tables 23 and 24, respectively, provide estimates of the deductions and potential losses to the Treasury if members of the 300-firm sample chose to self-insure under this proposition. If they chose to self-insure fully, the potential extra loss to the Treasury could be $19 million. If all the firms in the industries represented by those 300 firms chose to self-insure under this proposition, the extra loss to Treasury could be up to $296 million -- as shown in Table 25.

TABLE 23. Potential Deductions for Product Liability Insurance Where Deductions are Based on Dollar Limitations vs. Severity of Risk Plus Reserve and Investment Income for a Random Sample of 300 Firms. 1/

	Deductions (in millions of dollars)			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self insurance
Under Proposition				
Industrial machinery	48	47	46	45
Grinding wheels	79	78	77	76
Ferrous castings	161	160	159	158
Industrial chemicals	119	118	117	116
Aircraft components	99	98	97	96
Auto components	69	68	67	66
Medical devices	95	94	93	92
Pharmaceuticals	78	77	76	75
Lawnmowers	69	68	67	66
Other	16	16	15	15
TOTAL	833	824	814	805
Under Present Law				
Industrial machinery	43	43	43	43
Grinding wheels	75	75	75	75
Ferrous castings	156	156	156	156
Industrial chemicals	114	114	114	114
Aircraft components	94	94	94	94
Auto components	64	64	64	64
Medical devices	90	90	90	90
Pharmaceuticals	73	73	73	73
Lawnmowers	65	65	65	65
Other	14	14	14	14
TOTAL	788	788	788	788
Difference between Present Law and Proposition				
Industrial machinery	5	4	3	2
Grinding wheels	4	3	2	1
Ferrous castings	5	4	3	2
Industrial chemicals	5	4	3	2
Aircraft components	5	4	3	2
Auto components	5	4	3	2
Medical devices	5	4	3	2
Pharmaceuticals	5	4	3	2
Lawnmowers	4	3	2	1
Other	2	2	1	1
TOTAL	45	36	26	17

1/ Calculations by BRIMMER & COMPANY from: 1) Sales figures in the 1978 Dun & Bradstreet Directory, and 2) Product Liability Insurance Premium rates from the Insurance Study Final Report, Interagency Task Force on Product Liability.

TABLE 24. Potential Loss to U.S. Treasury for Product Liability Insurance Where Deductions are Based on Dollar Limitations vs. Severity of Risk Plus Reserve and Investment Income for a Random Sample of 300 Firms. 1/

	Loss (in millions of dollars)			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self insurance
Under Proposition V				
Industrial machinery	22	22	21	21
Grinding wheels	37	37	37	36
Ferrous castings	77	77	76	75
Industrial chemicals	56	56	55	55
Aircraft components	47	47	46	46
Auto components	33	33	32	32
Medical devices	45	45	44	44
Pharmaceuticals	37	37	36	35
Lawnmowers	32	32	32	31
Other	7	7	7	6
TOTAL	393	393	386	381
Under Present Law				
Industrial machinery	20	20	20	20
Grinding wheels	36	36	36	36
Ferrous castings	74	74	74	74
Industrial chemicals	54	54	54	54
Aircraft components	45	45	45	45
Auto components	31	31	31	31
Medical devices	43	43	43	43
Pharmaceuticals	34	34	34	34
Lawnmowers	31	31	31	31
Other	6	6	6	6
TOTAL	374	374	374	[illegible]
Difference between Present Law and Proposition				
Industrial machinery	2	2	1	1
Grinding wheels	1	1	1	0
Ferrous castings	3	3	2	1
Industrial chemicals	2	2	1	1
Aircraft components	2	2	1	1
Auto components	2	2	1	1
Medical devices	2	2	1	1
Pharmaceuticals	3	3	2	1
Lawnmowers	1	1	1	0
Other	1	1	1	0
TOTAL	19	19	12	7

1/Calculations by BRIMMER & COMPANY from deductions as reported in Table 23, using a tax rate for each firm of 20 per cent of the first $25,000; 22 per cent of the second $25,000; and 48 per cent of the balance.

TABLE 25. Potential Loss to U.S. Treasury for Product Liability Insurance Where Deductions are Based on Dollar Limitations vs. Severity of Risk Plus Reserve and Investment Income for Industries Represented by the 300 Firms. 1/

	LOSS (in millions of dollars)			
	100 per cent self-insurance	90 per cent self-insurance	60 per cent self-insurance	30 per cent self-insurance
(a) Under Proposition V 2/ (Selected industries guide)				
Industrial machinery	30	27	18	9
Grinding wheels	*	*	*	*
Ferrous castings	7	6	4	2
Industrial chemicals	6	5	4	2
Aircraft components	2	2	1	1
Auto components	27	24	16	8
Medical devices	2	2	1	11
Pharmaceuticals	5	5	3	2
Lawnmowers	*	*	*	*
Other	71	64	43	21
TOTAL	150	135	90	45
(b) (Manufacturers' sales guide) 3/				
Industrial machinery	53	48	32	16
Grinding wheels	*	*	*	*
Ferrous castings	5	4	3	2
Industrial chemicals	47	42	28	14
Aircraft components	**	**	**	**
Auto components	34	31	20	10
Medical devices	*	*	*	*
Pharaceuticals	*	*	*	*
Lawnmowers	*	*	*	*
Other	157	141	94	47
TOTAL	296	266	177	89

* Total industry figures not available, hence included in "other" category.

** Estimate combined with "auto components" below, representing the transportation equipment industry.

1/ Calculations by BRIMMER & COMPANY from the losses as reported in Table 24 showing loss to the U.S. Treasury for a random sample of 300 firms.

2/ Estimated loss based on "value of shipments" by selected manufacturing industries in 1977, reported in U.S. Department of Commerce, U.S. Industrial Outlook, 1978, Appendix A, pp. 465-468.

3/ Estimated loss based on "Manufacturers' Sales (shipments)" by major industry group in 1976, reported in U.S. Department of Commerce, Survey of Current Business, April, 1978, pp. S-5 and S-6.

SECTION IV

SUMMARY AND CONCLUSIONS

This study was undertaken to obtain quantitative estimates of the potential impact on public sector revenues of the various proposals to provide Federal Government tax incentives for self-insurance against product liability losses. The study was initiated against a background of complaints by a number of manufacturers that such coverage has become unavailable or unaffordable. While spokesmen for the insurance industry have denied these charges, several members of Congress have responded by introducing a variety of bills which would provide tax incentives to self-insure. The Carter Administration (through the U.S. Department of Commerce) has also fashioned a proposal which seeks the same goal.

In April, 1976, the Federal Government established an Interagency Task Force on Product Liability to examine the status of product liability. After a great deal of probing, the Task Force issued its report in 1977. The group's key conclusion can be summarized briefly:

(1) "There is no widespread problem of product liability insurance being unavailable. A few companies in the Task Force's target industries and other high-risk product lines are having difficulty obtaining product liability insurance. For some others, product liability rates would appear to be unaffordable -- it has been persuasively argued to the Task Force that this is a practical equivalent of unavailability.

(2) "There has been a substantial increase in the cost of product liability insurance in 1974 in all of the Task Force's target industries. The increase in premiums appears to have been greater

for small as compared to large businesses. Also, small firms appear less able to cope with affordability problems than large firms. Certain industries appear to have been subject to very substantial increases. These include manufacturers of medical devices, pharmaceuticals, power lawnmowers, industrial chemicals, and metal castings."

Estimating Technique

In study, five (5) different propositions were assessed, and their potential impact on the U.S. Treasury was estimated. The essential characteristics of the five alternatives with respect to the Federal treatment of tax deductions for self-insurance can be summarized briefly. The proposed legislation which embodies at least some of the key elements of each alternative can also be identified:

Proposition	Characteristics	Legislative Proposal
I	Ordinary risk (2 per cent of gross receipts).	H.R. 8064
II	Ordinary plus severe risk (5 per cent of gross receipts).	U.S. Department of Commerce Proposal
III	Fair Market Value.	H.R. 7711 H.R. 10272
IV	Fair Market Value plus reserve and investment income.	H.R. 771 H.R. 10272
V	Dollar limitation vs. severity of risk plus reserve and investment income.	U.S. Department of Commerce Proposal

The potential revenue losses to the U.S. Treasury (and to the various States) could not be calculated directly -- because a lack of

both time and resources prevented a canvass of either taxpayers or tax collectors. Instead, the estimates had to be made indirectly on the basis of statistical data from a number of different sources. The estimates for the U.S. Treasury rest on two main sets of information: (1) figures for 856 corporations with sales of $100 million or more, and (2) sales for a sample of 300 firms -- most of which were concentrated in industries in which severe product liability problems have been encountered.

To determine the potential impact of the alternative proposals on the U.S. Treasury, it was first necessary to estimate the present deductions taken by business firms for premiums paid to conventional insurance companies. (The calculations made necessarily result in an under-estimation of the losses; there is no way to measure the deviation from standard premiums paid by large corporations -- although there is evidence of such deviations in practice. The potential reduction in U.S. Treasury revenue was determined by calculating the difference between the loss under the present provisions of the Internal Revenue Code and the losses which might result under the various alternatives.

The main findings of the study can be summarized here:

Losses to the U.S. Treasury

If the 856 large corporations (with sales of $100 million and over) were to take the deductions allowed under any one of the five propositions analyzed in this study, there would be losses to the U.S. Treasury. As shown in Table 26, the losses could range from $36 million to $12 billion, depending upon the specific alternative.

TABLE 26: Summary of the Potential Deductions and Loss to the U.S. Treasury for Product Liability Insurance Coverage Under Various Alternatives, If 856 Corporations Self Insure 100 Per Cent. 1/

Corporations 2/	DEDUCTIONS FOR THE 856 CORPORATIONS WITH SALES $100 MILLION AND OVER (100 Per Cent)				
	(in millions of dollars) 3/	PROPOSITIONS			
	I	II	III	IV	V
100 Corporations	2,898	4,098	809	3,498	11
200 Corporations	4,084	6,362	1,047	4,349	24
300 Corporations	6,578	11,169	1,658	6,352	39
400 Corporations	8,271	15,209	1,972	7,406	52
500 Corporations	9,600	17,673	2,241	8,308	64
600 Corporations	11,110	20,068	2,441	9,232	76
700 Corporations	12,106	22,039	2,708	9,749	87
856 Corporations	14,612	25,639	3,024	10,866	106

Corporations 3/	LOSS TO THE U. S. TREASURY IF 856 CORPORATIONS SELF INSURE (100 Per Cent)				
	(in millions of dollars) 3/	PROPOSITIONS			
	I	II	III	IV	V
100 Corporations	1,358	1,962	388	1,438	3
200 Corporations	1,960	3,053	502	1,782	8
300 Corporations	3,158	5,360	795	2,618	14
400 Corporations	3,970	7,299	946	3,035	18
500 Corporations	4,609	9,482	1,075	3,488	23
600 Corporations	5,834	9,632	1,171	3,789	28
700 Corporations	5,812	10,587	1,299	4,014	32
856 Corporations	7,014	12,307	1,452	4,480	40

1/Calculations by BRIMMER & COMPANY from: 1)Sales data provided by the 856 corporations on Form 10-K filed with the Securities and Exchange Commission; 2)Product Liability Insurance premium rates from the Insurance Study Final Report, Interagency Task Force on Product Liability; and 3)A tax rate for each corporation of 20 per cent of the first $25,000; 22 per cent of the second $25,000; and 48 per cent of the balance.

2/The corporations were divided into groups of 100, each group containing companies of various sizes and manufacturing a variety of products.

3/Figures are cumulative.

Several factors help to explain the variation in the amount of the loss which might occur under the different propositions:

(1) The rate used in determining the deduction. If, as was the assumption in this study, the average premium rate for all products (except those in the severe product category) is .34 per cent, a deduction allowed under the alternative involving 2 per cent or 5 per cent of sales would substantially increase the loss to the U.S. Treasury. Propositions I and II provide for deductions above the present premium rate.

If the deductions are based on fair market value, the U.S. Treasury would also experience a loss (Propositions III and IV). In general, were a proposition allowing self-insurance to be enacted, the following reactions could be expected:

- More large corporations may be inclined to self-insure and for a larger percentage of their product liability coverage.
- If the large corporations no longer insure with the conventional insurance comapnies at the present level, those insurance companies may be inclined to raise their premium rates.

In calculating the fair market value, it was assumed that the premium rate might increase by 41 per cent. This is a key assumption underlying the estimates for Proposition III. Some argue that the fair market value would be equivalent to the present premium rates. Were that the case, there would be no loss the U.S. Treasury were Proposition III enacted.

(2) Deductions are allowed for accumulated earnings. At least one of the product liability self-insurance proposals now

being considered amends Section 537 of the Internal Revenue Code. The change would allow amounts accumulated in the loss reserve account or paid to a captive insurer to be deductib ecause the funds are accumulated for reasonably anticipated ne There is a loss to the Treasury in the case of those alternatives which allow deductions for accumulated earnings as well as deductions for contributions to the reserve and the reserve's investment income. The loss to the Treasury under Proposition IV for the 856 large corporations was estimated at $4 billion. Some argue that the type of enterprises represented by these large firms would not accumulate earnings in excess of the amounts necessary to meet the reasonably anticipated requirements of the business without some exemption. If that were true, the loss to the Treasury would be $1.6 billion instead of the $4 billion for the 856 corporations.

(3) Deductions are allowed for investment income. Propositions IV and V allow deductions for investment income from the amounts in the reserve account. This element also helps to explain the differential size of the losses to the U.S. Treasury.

If the members of the 300-firm sample were to self-insure under any one of the alternatives, the U.S. Treasury would experience a loss in revenue. As shown in Table 27 the loss may vary between $19 million and $1.9 billion, depending on which proposition is adopted. The largest share of the losses would be concentrated in the metal casting industry, and the smallest share would occur in industries producing industrial machinery. Table 28 summarizes the

TABLE 21. Summary of the Potential Deductions and Loss to the U.S. Treasury for Product Liability Insurance Coverage Under Various Alternatives, If the Random Sample of 300 Firms Distributed Across 10 Industrial Classes Self Insure 100 Per Cent. 1/

Industrial Classes	DEDUCTIONS BY INDUSTRIAL CLASS FOR THE 300 CORPORATIONS (100 Per Cent)				
	PROPOSITIONS				
	I	II	III	IV	V
Industrial machinery	51	156	13	65	5
Grinding wheels	88	334	29	109	4
Ferrous castings	272	913	68	236	5
Industrial chemicals	142	526	64	160	5
Aircraft components	136	477	37	130	5
Auto components	26	297	32	107	5
Medical devices	114	420	39	138	5
Pharmaceuticals	95	346	27	104	5
Lawnmowers	79	296	32	107	4
Other	82	231	13	33	2
TOTAL	1,085	3,996	359	1,197	45

Industrial Classes	LOSS TO THE U.S. TREASURY BY INDUSTRIAL CLASS FOR THE 300 CORPORATIONS (100 Per Cent)				
	PROPOSITIONS				
	I	II	III	IV	V
Industrial machinery	24	75	9	29	2
Grinding wheels	42	160	14	41	1
Ferrous castings	131	438	32	96	3
Industrial chemicals	69	253	31	66	2
Aircraft components	65	229	18	55	2
Auto components	12	142	15	43	2
Medical devices	55	202	19	55	2
Pharmaceuticals	46	166	13	44	3
Lawnmowers	38	142	15	42	1
Other	39	111	6	13	1
TOTAL	521	1,918	172	486	19

1/Calculations by BRIMMER & COMPANY from: 1)Sales data in the 1978 Dun & Bradstreet Directory; 2)Product Liability Insurance premium rates from the Insurance Study Final Report, Interagency Task Force on Product Liability; and 3)A tax rate for each corporation of 20 per cent of the first $25,000; 22 per cent of the second $25,000; and 42 per cent of the balance.

TABLE 26. Summary of the Potential Deductions and Loss to the U.S. Treasury for Product Liability Insurance Coverage Under Various Alternatives, If the Random Sample of 300 Firms Self Insure 100 Per Cent. 1/

DEDUCTIONS FOR THE 300 CORPORATIONS IF THEY SELF-INSURE (100 Per Cent)

PROPOSITIONS				
I	II	III	IV	V
1,085	3,996	359	1,197	45

LOSS TO THE U. S. TREASURY IF THE 300 CORPORATIONS SELF-INSURE (100 Per Cent)

PROPOSITIONS				
I	II	III	IV	V
521	1,918	172	486	19

1/ Calculations by BRIMMER & COMPANY from : 1)Sales data in the 1978 Dun & Bradstreet Directory; 2)Product Liability Insurance premium rates from the Insurance Study Final Report, Interagency Task Force on Product Liability; and 3) A tax rate for each corporation of 20 per cent of the first $25,000; 22 per cent of the second $25,000; and 42 per cent of the balance.

potential deductions and potential losses to the U.S. Treasury if the members of the 300-firm sample were to self-insure 100 per cent. Table 29 summarizes the same results if all industries represented by the 300-firm sample were to self-insure fully.

Summary of Specific Alternatives

Proposition I. Ordinary Risk (deductions for 2 per cent of gross receipts).

If the 856 large corporations chose to self-insure totally, the potential loss to the Treasury could be $9.4 billion. If the firms in the industries represented by the 300 firms in the random sample were to self-insure, the potential loss would be $6.6 billion. The losses to the U.S. Treasury can be attributed to the fact that 2 per cent of gross receipts is a much higher level of deductions than would be the case under the present Internal Revenue Code, where deductions are taken for premiums paid to conventional insurance companies.

Proposition II. Ordindary Plus Severe Risk (deductions for 5 per cent of gross receipts).

If the 856 corporations chose to self-insure totally, under this proposition, the potential loss to the Treasury would be $12.3 billion. If the enterprises in the industries represented by the 300-firm sample were to self-insure, the loss would be $23.2 billion. As was the case under Proposition I, the loss can be attributed to the fact that the rate is much higher under this proposition than the present premium rates.

Proposition III. Deductions for fair market value.

If the 856 corporations chose to self-insure fully under this

TABLE 29. Summary of the Potential Loss to the U.S. Treasury for Product Liability Insurance Coverage under Various Alternatives If All Industries Represented by the 300 Firms Self Insure 100 Per Cent 1/

LOSS TO THE U.S. TREASURY IF ALL INDUSTRIES SELF INSURE (100 PER CENT)

(Selected Industries Guide) 2/	PROPOSITIONS			
I	II	III	IV	V
4,050	15,266	1,392	3,929	150

LOSS TO THE U.S. TREASURY IF ALL INDUSTRIES SELF INSURE (100 PER CENT)

(Manufacturers' Sales Guide) 3/	PROPOSITIONS			
I	II	III	IV	V
6,657	23,202	2,133	6,152	296

1/ Calculations by BRIMMER & COMPANY from the losses as reported in TABLE 29, showing the loss to the U.S. Treasury for the random sample of 300 firms.
2/ Estimated loss based on "value of shipments" by selected manufacturing industries in 1977, reported in U.S. Department of Commerce, U.S. Industrial Outlook, 1978, Appendix A, pp. 465-468.
3/ Estimated loss based on "Manufacturers' Sales (shipments)" by major industry group in 1976, reported in U.S. Department of Commerce, Survey of Current Business, April, 1978, pp. S-5 and S-6.

alternative, the potential loss to the U.S. Treasury would be $1.5 billion. If the firms in the industries represented by the 300 firms chose to self-insure under this proposition, the loss would be $2.1 billion. The loss to the Treasury is attributed to the assumption in the study that the premium rates would increase by 41 per cent (if this proposition were enacted) because the insurance companies would raise their rates when the large corporations chose self-insurance.

Proposition IV. Deductions for fair market value plus reserve and investment income.

If the 856 large corporations chose to self-insure totally under this proposition, the potential loss to the Treasury would be $4.5 billion. If the firms in the industries represented by the 300 firms in the sample chose to self-insure under this version, the loss would be estimated at $6.2 billion. The increase in the loss to the Treasury over and above the loss under Proposition III can be attributed to the deductions for accumulated earnings as well as for investment income.

Proposition V. Dollar limitation vs. severity of risk. (deductions for the lesser of $100,000/$25,000 or 5 per cent/2 per cent of gross receipts) plus reserve and investment income.

The potential loss to the U.S. Treasury if the 856 large corporations were to self-insure fully is estimated at $40 million. If the firms represented by the industries in the 300-firm sample chose to self-insure under this proposition, the estimated loss to the Treasury is $296 million. Although this alternative places a

limitation of $100,000 and $25,000 on the amount of the deduction (depending upon the presence or absence of a severe product liability insurance problem), there will be a loss to the U.S. Treasury. This study is based on the assumption that the large corporations will take advantage of the deductions allowed under this proposition -- in addition to deductions for coverage by the conventional insurance corporations.

Concluding Observations

Again, it must be emphasized that the estimates of potential revenue losses presented here are based on a number of key assumptions. They must be kept in mind when the figures are interpreted.

Central to the analysis here was the assumption that most corporations exposed to product liability would choose to self-insure -- if they had a tax incentive. Of course, this will not be the case in practice. Many of the smaller firms could not afford to self-insure. They do not have the capital to pay large product claims, and one loss could exceed one year's total sales. Moreover, such firms do not have captive insurance companies, and commercially available product liability policies do not have deductibles. Whenever available at reasonable cost, the smaller firms will probably continue to purchase insurance -- already a tax deduction.

The above considerations suggest that the U.S. Treasury is not likely to lose much revenue because small firms choose to self-insure. To change the situation, tax incentive proposals would have to be designed specifically for small businesses. Thus, the large corporations are the ones most likely to self-insure, thereby creating the revenue losses for the Federal Government.

35-992 O - 79 - 21

APPENDIX TABLES

BASIC DATA SOURCES

Table		Page
A.	Sales Ranking of 856 Large Corporations, 1977	
B.	Distribution of 300-Company Sample, By Size of Sales, 1977	
C.	Value of Shipments of Selected Manufacturing Industries, 1977	
D.	Manufacturer's Sales (Shipments), By Major Industry Group, 1976	
E.	Product Liability Rates For Target Product Categories	

APPENDIX TABLE A. SALES RANKING OF 856 LARGE CORPORATIONS, 1977

Company	Sales Ranking	Company	Sales Ranking
*ACE Industries	301	*American Can	64
AMAX	191	*American Chain & Cable	482
AMF	201	American Crystal Sugar	684
AMP	356	American Cyanamid	107
APL	098	American Greetings	575
*A-T-O	357	American Hoist & Derrick	428
Abbott Laboratories	209	American Home Products	89
Acme-Cleveland	681	American Maize-Products	609
Addressograph Multigraph	334	American Motors	94
*Affiliated Publications	883	American Petrofina	212
Agway	162	American Ship Building	830
*Air Products & Chemicals	264	American Standard	134
*Airco	260	American Sterilizer	757
Akzona	282	Ameron	650
Alabama By-Products	719	Ametek	599
*Alan Wood Steel	741	*Ampco-Pittsburgh	983
Alaska Interstate	716	Ampex	571
*Albany International	601	*Amstar	199
Alberto-Culver	797	Amsted Industries	373
Alleghany Corp.	632	Amtel	493
Allegheny Ludlum Industries	244	*Anaconda	151
Allen Group	570	Anchor Hocking	304
Allied Chemical	82	Anderson, Clayton	274
Allied Products	568	Angelica	992
Allis-Chalmers	146	Anheuser-Busch	156
Alton Box Board	610	Ansul	972
*Alumax	352	Apache	707
Aluminum Co. of America	72	*Apco Oil	512
Amalgamated Sugar	711	Apeco	954
Ambac Industries	663	Applied Power	811
*Amcord	672	Arcata National	530
Amerace	581	Archer-Daniels-Midland	138
Amerada Hess	48	Arizona-Colorado Land & Cattle	875
*American Air Filter	592	Armco Steel	63
American Bakeries	400	Armstrong Cork	230
American Beef Packers	693	Armstrong Rubber	497
American Biltrite	695	Arvin Industries	432
American Brands	80	Asarco	203
*American Broadcasting	170	Ashland Oil	43
American Business Products	978	Associated Coca-Cola Bottling	737

* Not included either because sales information not available at the Securities and Exchange Commission (Form 10-Ks) at the time of the research or because the company fell in the "excluded" categories (banks, insurance companies, services).

Company	Sales Ranking
*Associated Milk Producers	137
Athlone Industries	623
Atlantic Richfield	15
*Atlantic Steel	974
Avco	305
Avery International	463
Avnet	309
Avon Products	157
Avondale Mills	597
Babcock & Wilcox	129
Baker International	342
Ball	433
Bally Manufacturing	666
Bandag	706
Bangor Punta	551
Banta (George)	867
Barber-Greene	826
Bard (C.R.)	778
Barnes Group	598
Barwick (E.T.) Industries	779
Bassett Furniture Industries	624
Bates Manufacturing	931
Bausch & Lomb	475
Baxter Travenol Laboratories	294
Beatrice Foods	38
Beckman Instruments	595
Becton, Dickinson	367
Beech Aircraft	477
Beker Industries	838
Belco Petroleum	468
Belden	698
Belding Heminway	964
Bell & Howell	391
Bemis	315
Bendix	70
Bethlehem Steel	33
Betz Laboratories	808
Bibb	745
Bic Pen	872

Company	Sales Ranking
Big Three Industries	556
Bird & Son	608
Black & Decker Manufacturing	276
*Blair (John)	924
Bliss & Laughlin Industries	722
Block Drug	895
Blue Bell	281
Bluebird	430
Bobbie Brooks	747
Boeing	47
Boise Cascade	116
Borden	59
Borg-Warner	121
Bourns	930
Briggs & Stratton	502
Bristol-Myers	113
Brockway Glass	414
Brown-Forman Distillers	661
Brown Group	256
*Brunswick	247
Brunswick Pulp & Paper	817
Buckeye International	955
Bucyrus-Erie	379
Budd	215
*Bulova Watch	660
Bundy	976
Bunker Ramo	511
Burlington Industries	98
Burndy	840
Burroughs	120
Butler Manufacturing	522
Buttes Gas & Oil	813
*CBS	102
CCI	859
*CF Industries	354
C.H.B. Foods	758
CPC International	79
CTS	767
Cabot	389

Company	Sales Ranking
Cagle's	821
*California Computer Products	885
Cameron Iron Works	422
Campbell Soup	136
Campbell Taggart	291
Cannon Mills	393
*Capital Cities Communications	641
Capitol Industries--EMI	732
*Carbon Industries	913
*Carborundum	313
Carlisle	798
Carnation	103
Carpenter Technology	564
Carrier	199
Carter-Wallace	743
Castle & Cooke	250
Caterpillar Tractor	36
Ceco	582
Celanese	106
Central Soya	124
Cerro-Marmon	249
Certain-teed	297
Cessna Aircraft	377
Chamberlain Manufacturing	754
Champion Home Builders	649
Champion International	74
Champion Spark Plug	362
Charter	192
Chelsea Industries	677
Chemetron	390
Chesapeake Corp. of Virginia	787
Chesebrough-Pond's	277
Chicago Bridge & Iron	331
Chicago Pneumatic Tool	559
*Chickasha Cotton Oil	909
Chock Full O' Nuts	792
*Christensen	893
Chromalloy American	242
*Chrysler	10
Church & Dwight	993
Cincinnati Milacron	398

Company	Sales Ranking
Cities Service	45
Clark Equipment	180
Clark Oil & Refining	285
Cleveland-Ciffs Iron	622
Clorox	262
Clow	905
Cluett, Peabody	330
Coachmen Industries	628
Coca-Cola	69
Coca-Cola Bottling Co. of L.A. ...	739
Coca-Cola Bottling Co. N.Y.	552
Coleco Industries	915
Coleman	611
Colgate-Palmolive	54
Collins & Aikman	440
Colt Industries	178
*Columbia Pictures Industries	488
*Combined Communications	702
*Combustion Engineering	125
*Combustion Equipment Associates	850
*Commerce Clearing House	805
Commercial Shearing	848
*Commonwealth Oil Refining	211
ConAgra	346
Condec	620
Cone Mills	326
*Congoleum	442
*Conrac	880
*Consolidated Aluminum	343
Consolidated Foods	78
Consolidated Papers	535
*Container Corp. of America	237
Continental Copper & Steel Ind. ..	938
Continental Group	56
Continental Oil	17
*Control Data	173
*Cook Industries	380
Cook Paint & Vanish	937
Cooper Industries	340
Cooper Tire & Rubber	600
Coors (Adolph)	321

Company	Sales Ranking
*Copeland	662
Copperweld	529
*Corning Glass Works	219
*Cox Broadcasting	846
Crane	208
*Crompton	967
Crompton & Knowles	772
Crouse-Hinds	584
Crown Central Petroleum	365
*Crown Cork & Seal	248
*Crown Zellerbach	104
*Cubic	947
Cummins Engine	218
Curtiss-Wright	491
Cutler-Hammer	401
Cyclops	337
Cyprus Mines	518
*DHJ Industries	755
*Dairylea Cooperative	460
Dan River	372
*Dana	155
*Dart Industries	152
Data 100	881
Data General	753
Dayco	375
Dayton Malleable	789
*Dean Foods	523
Deere	66
*De Laval Turbine	548
*Dellwood Foods	962
Del Monte	158
*DeLuxe Check Printers	605
Dennison Manufacturing	534
*Dentsply International	816
DeSoto	540
Dexter	696
*Diamond International	252
*Diamond Shamrock	167
*Dibrell Brothers	648
Dick (A.B.)	520
Dictaphone	831

Company	Sales Ranking
Diebold	709
Digital Equipment	280
Dinner Bell Foods	837
*Diversey	907
*Dixie Yarns	780
*Donaldson	886
*Donnelley (R.R.) & Sons	327
*Dorsey	654
*Dover	462
Dow Chemical	25
*Dow Corning	471
*Dow Jones	555
*Downe Communications	922
*Dresser Industries	101
Dr Pepper	777
Du Pont (E.I.) de Nemours	16
Dymo Industries	685
Dynamics Corp. of America	957
Dynascan	989
*EDG	940
EG&G	578
E-Systems	509
Eagle-Picher Industries	431
Early California Industries	991
Earth Resources	563
Easco	621
Eastern Gas & Fuel Associates	298
Eastman Kodak	28
Eastmet	770
Eaton	127
Echlin Manufacturing	659
*Economics Laboratory	494
*Elixir Industries	891
Eltra	265
Emerson Electric	147
Emery Industries	748
Emhart	202
Envirotech	424
Esmark	32
Esterline	866
Ethan Allen	749

Company	Sales Ranking
Ethyl	194
Evans Products	270
Ex-Cell-O	423
Exxon	1
FMC	97
Faberge	665
Fairchild Camera & Instrument	404
Fairchild Industries	569
Fairmont Foods	358
Falstaff Brewing	799
Fansteel	981
Farah Manufacturing	814
Farmland Industries	123
Fedders	539
Federal Co.	348
Federal-Mogul	412
Federal Paper Board	437
Ferro	451
Fibreboard	521
Fieldcrest Mills	480
Filmways	998
*Firestone Tire & Rubber	46
*First Mississippi	790
Fischer & Porter	835
*Flavorland Industries	450
Fleetwood Enterprises	439
Flintkote	370
Florida Steel	943
*Flowers Industries	711
Ford Motor	3
Fort Howard Paper	614
Foster Wheeler	214
Foxboro	500
*Franklin Electric	988
Franklin Mint	519
Frederick & Herrud	469
Freeport Minerals	517
Fruehauf	153
Fuller (H.B.)	733
GAF	216
GATX	341
GF Business Equipment	966

Company	Sales Ranking
*Gannett	426
Gardner-Denver	403
Gates Learjet	721
General American Oil Co. of Texas	960
General Cable	474
General Cinema	458
General Dynamics	85
General Electric	9
General Felt	996
General Foods	44
General Host	299
General Instument	443
General Mills	81
General Motors	2
General Portland	712
General Refractories	503
General Signal	312
General Tire & Rubber	111
Genesco	196
*Georgia Kraft	680
Georgia-Pacific	68
Gerber Products	453
Getty Oil	67
Gifford-Hill	567
Gillette	150
Globe-Union	541
Glover	704
Gold Kist	251
Goodrich (B.F.)	112
Goodyear Tire & Rubber	23
Gould	185
Goulds Pumps	786
Grace (W.R.)	50
Graniteville	533
*Great Northern Nekoosa	259
*Great Western United	359
Green Giant	392
*Greif Bros.	682
Grayhound	49
*Grolier	586
*Grumman	148
Guardian Industries	820

Company	Sales Ranking
Guilford Mills	897
Gulf Oil	7
Gulf Resources & Chemical	513
Gulf & Western Industries	57
*Hall (W.F.) Printing	903
Hammermill Paper	293
*Hammond	901
Handy & Harman	476
Hanes	455
Hanna Mining	461
*Harcourt Brace Jovanovich	560
*Harman International Industries	818
Harnischfeger	407
Harris	361
Harsco	322
Hart Schaffner & Marx	349
*Harte-Hanks Newspapers	920
Hartz Mountain	655
Harvey Hubbell	686
Hasbro Industries	958
Hayes-Albion	668
Heileman (G.) Brewing	644
Heinz (H.J.)	119
*Helene Curtis	971
Hercules	142
Hershey Foods	328
Hesston	690
Heublein	176
Hewlett-Packard	200
Hillenbrand Industries	841
Hines (Edward) Lumber	612
Hobart	415
*Hoerner Waldorf	366
Holly	849
Holly Sugar	636
Homestake Mining	857
Hon Industries	980
Honeywell	88
*Hood (H.P.)	417
Hover	335

Company	Sales Ranking
Hoover Ball & Bearing	499
Hormel (Geo. A.)	206
Houdaille Industries	496
Houghton Mifflin	952
Houston Oil & Minerals	861
Hudson Pulp & Paper	761
Huffman Manufacturing	956
Hughes Tool	448
Huyck	963
Hydrometals	887
*Hygrade Food Products	382
Hyster	454
IC Industries	130
Ideal Basic Industries	531
*Ideal Toy	847
Idle Wild Foods	495
Illini Beef Packers	750
Illinois Tool Works	576
*Imperial Sugar	862
Indian Head	355
*Ingersoll-Rand	117
Inland Container	435
Inland Steel	92
*Inmont	350
Insilco	444
Instrument Systems	639
Intel	625
Interco	165
Interlake	289
International Business Machines	8
International Flavors & Fragrances	558
International Harvester	27
International Minerals & Chemical	181
International Multifoods	268
International Paper	52
International Systems & Controls	489
International Tel. & Tel.	11
Interpace	542
*Interstate Brands	410
Iowa Beef Processors	109

Company	Sales Ranking
Itek	652
Jantzen	868
Johns-Manville	174
Johnson & Johnson	87
Johnson Controls	506
Jonathan Logan	449
Joslyn Mfg. & Supply	785
Jostens	746
Joy Manufacturing	302
KDI	839
Kaiser Aluminum & Chemical	122
*Kaiser Cement & Gypsum	643
*Kaiser Industries	222
Kane-Miller	269
Kaneb Services	914
Katy Industries	751
*Kawecki Berylco Industries	941
Keene	829
Keller Industries	863
Kellogg	163
Kellwood	418
Kennametal	815
Kennecott Copper	234
Kerr Glass Manufacturing	580
Kerr-McGee	114
*Kewanee Industries	411
Keystone Consolidated Industries	505
Keyes Fibre	906
Keystone Foods	842
Kidde (Walter)	184
Kimball International	874
Kimberly-Clark	143
*King-Seeley Thermos	657
Kirsch	948
*Knight-Ridder Newspapers	295
Knudsen	617
Koehring	470
Koppers	190
Koracorp Industries	800
Kraft	37
Kroehler Mfg.	736

Company	Sales Ranking
LTV	39
Laclede Steel	697
Lamson & Sessions	945
Lancaster Colony	717
Lance	776
*Land O'Lakes	183
Lane	916
La-Z-Boy Chair	977
Lear Siegler	292
Leeds & Northrup	806
Leesona	969
Leggett & Platt	910
Lehigh Portland Cement	896
Lehigh Valley Industries	894
Lenox	825
Leslie Fay	760
*Lever Brothers	275
Levi Strauss	186
Libbey-Owens-Ford	255
*Libby, McNeill & Libby	371
Liggett Group	283
Lilly (Eli)	171
*Lipton (Thomas J.)	363
Liquid Air Corp. of North America	565
Litton Industries	60
Lockheed Aircraft	61
Lone Star Industries	284
Longview Fibre	573
Louisiana Land & Exploration	479
Louisiana-Pacific	338
Lowenstein (M.) & Sons	351
Lubrizol	395
Ludlow	627
Lukens Steel	587
Lykes	140
MAPCO	419
MBPXL	266
MCA	267
Macmillan	376
Magic Chef	589
Mallinckrodt	553

Company	Sales Ranking
Mallory (P.R.)	507
*Management Assistance	873
Manhattan Industries	607
Manitowoc	701
Mansfield Tire & Rubber	870
Marathon Manufacturing	536
Marathon Oil	55
Maremont	514
Marhoefer Packing	819
Marlene Industries	902
Marley	616
Martin Marietta	189
Martin Processing	918
Maryland Cup	515
Masco	420
Masland (C.H.) & Sons	836
Masonite	446
Mattel	486
Maytag	554
McCord	774
McCormick	525
McCulloch Oil	851
McDonnell Douglas	51
McDonough	545
McGraw-Edison	224
*McGraw-Hill	323
McLouth Steel	364
McNeil	714
*McQuay-Perfex	769
Mead	141
*Media General	673
Medtronic	828
Medusa	658
Memorex	481
Merck	132
*Meredith	691
Mesta Machine	936
*Metromedia	562

Company	Sales Ranking
Michigan General	728
Mickelberry	939
*Midland Cooperatives	516
Midland Glass	929
Midland-Ross	425
Miles Laboratories	397
Milton Bradley	687
Mine Safety Appliances	710
Minnesota Mining & Manufacturing	53
Mirro Aluminum	946
*Mississippi Chemical	634
Mitchell Energy & Development	804
Mobil	5
Modine Manufacturing	911
Mohasco	306
Mohawk Data Sciences	752
Mohawk Rubber	708
Monfort of Colorado	445
Monogram Industries	735
Monroe Auto Equipment	718
Monsanto	42
Morse Electro Products	888
Morton-Norwich Products	318
*Motorola	149
Munsingwear	982
Murphy Oil	229
Murray Ohio Manufacturing	781
NCR	96
NIBCO	876
NL Industries	175
*NVF	396
Nabisco	110
Nalco Chemical	447
Nashua	467
National Can	246
National Chemsearch	692
*National Coopérative Refinery Assn.	591
National Distiller and Chemical	193

Company	Sales Ranking
National Grape Co-Operative Assoc.	756
National Gypsum	314
National Homes	890
National Mine Service	973
National Presto Industries	834
National Semiconductor	504
National Service Industries	381
National-Standard	631
National Starch & Chemical	487
National Steel	76
*National Steel & Shipbuilding	629
Natomas	436
*Neptune International	921
*New York Times	394
Newmont Mining	317
*Norin	324
*Norlin Music	824
Norris Industries	416
North American Coal	561
North American Philips	128
Northrop	179
Northwest Industries	144
Northwestern Steel & Wire	574
Norton	303
Norton Simon	131
Noxell	877
Nucor	715
OKC	807
Oak Industries	802
Occidental Petroleum	26
*Ocean Spray Cranberries	935
Ogden	145
Oglebay Norton	933
Ohio Ferro-Alloys	919
*Okonite	858
Olin	164
Olinkraft	484
Olympia Brewing	546
Omark Industries	923
Oscar Mayer	197
Outboard Marine	329
Overhead Door	878

Company	Sales Ranking
*Owens-Corning Fiberglas	210
Owens-Illinois	84
Oxford Industries	526
PPG Industries	100
PVO International	775
Pabst Brewing	319
Paccar	227
Pacific Lumber	793
Pacific Resources	538
Palm Beach	762
Pantasote	997
*Park-Ohio Industries	904
Parker-Hannifin	429
*Parker Pen	809
*Peabody Coal	257
Peabody International	498
Peavey	369
Penn-Dixie Industries	550
Pennsylvania Engineering	917
Pennwalt	272
Pennzoil	221
*Pennzoil Offshore Gas Operators	845
PepsiCo	77
Perkin-Elmer	473
*Pet	223
Petrolite	871
*Pettibone	678
*Pfizer	118
Phelps Dodge	240
*Philip Morris	65
Philips Industries	724
*Phillips Petroleum	24
Phillips-Van Heusen	532
*Pillsbury	159
Piper Aircraft	645
Pitney-Bowes	347
Pittsburg-Des Moines Steel	669
Pittsburgh Forgings	773
Pittston	161
*Pittway	740
*Playboy Enterprises	674
Polaroid	239

Company	Sales Ranking
Portec	900
Porter (H.K.)	466
Potlatch	308
Powers Regulator	932
*Prentice-Hall	647
Procter & Gamble	19
Publicker Industries	856
Purex	388
Puritan Fashions	664
Quaker Oats	154
Quaker State Oil Refining	413
Quanex	852
Questor	406
RCA	31
*RKO General	768
Ralston Purina	58
Ranco	899
*Rath Packing	441
Raybestos-Manhattan	602
Raychem	723
Raytheon	90
Redman Industries	927
Reeves Brothers	603
Reichhold Chemicals	325
Reliznce Electric	298
Reliance Universal	889
Remington Arms	651
Republic	637
Republic Steel	86
Research-Cottrell	615
Revere Copper & Brass	374
Revlon	235
Rexham	953
Rexnord	300
Reynolds (R.J.) Industries	41
Reynolds Metals	108
Richardson	812
Richardson-Merrell	279
Riegel Textile	524
Riley	646

Company	Sales Ranking
Rival Manufacturing	912
Robertshaw Controls	585
Robertson (H.H.)	501
Robins (A.H.)	544
Roblin Industries	970
Rochester & Pittsburgh Coal	882
Rockwell International	34
Rohm & Haas	195
Rohr Industries	421
Ronson	935
Roper	464
*Rorer-Amchem	543
Royal Crown Cola	547
Royster	794
Rubbermaid	700
*Rucker	734
Russ Togs	823
Russell	864
SCM	172
*Safeguard Industries	961
St. Joe Minerals	271
St. Regis Paper	135
Salant	683
Sanders Associates	675
Savannah Foods & Industries	549
Saxon Industries	385
Schaefer (F. & M.)	638
Scherer (R.P.)	892
Schering-Plough	254
Schlitz (Jos.) Brewing	228
Schluderberg-Kurdle	994
Scholl	676
Scott & Fetzer	483
*Scott, Foresman	730
Scott Paper	166
Scovill Manufacturing	307
Seaboard Allied Milling	528
Seagram (Joseph E.) & Sons	241
Sealed Power	705
Searle (G.D.)	273

Company	Sales Ranking
*Seeburg Industries	860
Seneca Foods	759
Seven-Up	613
Shakespeare	995
Shaklee	729
Shaw Industries	999
Shell Oil	13
Sheller-Globe	384
Sherwin-William	238
Siegel (Henery I.)	950
Signal Companies	91
Signode	402
Simmons	387
Simplicity Pattern	942
Singer	105
Skil	801
Skyline	590
Smith (A.O.)	310
Smith International	510
SmithKline	296
Smithfield Foods	803
Smucker (J.M.)	944
Snap-on Tools	640
Sola Basic Industries	765
Sonoco Products	594
Soundesign	827
Southdown	588
Southland Royalty	854
*Southland Paper Mills	703
Southwest Forest Industries	344
Spencer Foods	360
*Sperry & Hutchinson	316
Sperry Rand	62
Springs Mills	311
Square D	353
Squibb	188
Staley (A.E.) Manufacturing	263
Stanadyne	618
Standard Brands	126

Company	Sales Ranking
Standard-Coosa Thatcher	934
Standard Oil of California	6
Standard Oil (Ind.)	12
Standard Oil (Ohio)	73
Standard Pressed Steel	763
Standard Products	796
Standard Register	731
Standex International	694
Stanley Home Products	738
Stanley Works	339
Stauffer Chemical	204
Steiger Tractor	979
Sterling Drug	205
Sterndent	832
Stevens (J.P.)	160
Stewart & Stevenson Services	688
Stewart-Warner	557
Stokely-Van Camp	386
Stone Container	579
Storage Technology	884
*Storer Broadcasting	844
Studebaker-Worthington	187
SuCrest	527
Sun	29
Sun Chemical	537
Sunbeam	236
Sundstand	320
Superior Oil	405
Susquehanna	951
Sybron	332
TFI Companies	784
TRW	71
Talley Industries	478
Tampax	782
Tappan	566
Tasty Baking	764
Technicare	984
Technicon	626
Technicolor	865

Company	Sales Ranking
Tecumseh Products	333
Tektronix	457
Teledyne	115
Telex	965
Tenneco	20
Terra Chemicals International	990
Tesoro Petroleum	213
Texaco	4
Texas Industries	810
*Texas Instruments	133
Texasgulf	383
Texfi Industries	670
Texstar	783
Textiles Inc	727
Textron	83
Thiokol	459
Thomas & Betts	855
Thomas Industries	843
*Time Inc.	217
*Times Mirror	232
Timken	253
*Titanium Metals Corp. Of America	635
Todd Shipyards	583
Toro	791
*Tosco	258
Tracor	853
Trane	409
*Trans Union	278
Triangle Industries	689
Triangle Pacific	713
*Trinity Industries	596
Tropicana Products	656
Tultex	959
*Twentieth Century-Fox Film	472
Twin Disc	879
Tyler	492
Tyson Foods	630
U and I	671
UMC Industries	653
UV Industries	368
Uarco	699
Unarco Industries	742

Company	Sales Ranking
Union	908
Union Camp	225
Union Carbide	21
Union Oil of California	30
Uniroyal	95
United Brands	99
United Merchants & Manufacturers	207
United Nuclear	1000
United Refining	508
U.S. Filter	465
U.S. Gypsum	233
U.S. Industries	169
*U.S. Steel	14
U.S. Sugar	926
U.S. Tobacco	744
United Technologies	35
Universal Foods	720
Universal Leaf Tobacco	290
Upjohn	220
*VF	399
*VSI	788
Valley Industries	986
*Valley Nitrogen Producers	869
Valmac Industries	766
Valmont Industries	975
Van Dorn	822
Varian Associates	485
Vermont American	968
Vetco	725
*Victor Comptometer	619
Vulcan, Inc.	987
Vulcan Materials	427
Walco National	928
Wallace Murray	490
Walter (Jim)	177
Ward Foods	378
Warnaco	438
Warner Communications	261
Warner-Lambert	93
Warner & Swasey	577
*Washington Post	452
Wean United	606

Company	Sales Ranking
*Weatherhead	833
*Weil-McLain	633
West Point-Pepperell	287
Western Electric	18
Western Gear	726
*Western Publishing	604
Westinghouse Electric	22
Westmoreland Coal	408
Westvaco	245
Weyerhaeuser	75
Wheelabrator-Frye	434
Wheeling-Pittsburgh Steel	243
Whirlpool	139
White Consolidated Industries	182
White Motor	168
Whiting	949
Whittaker	286
Willamette Industries	345
Williams Companies	226
Winnebago Industries	642
Witco Chemical	336
Wolverine World Wide	795
*Wometco Enterprises	667
Work Wear	679
Worthington Industries	985
Wrigley (Wm.) Jr.	456
Wyman-Gordon	572
Xerox	40
Zenith Radio	231
Zurn Industries	593
ALCO Standard	
American Seating Co.	
Banner Industries	

Source: Fortune 1000, 1978.

Company
Bond Industries
Bottemia, Inc.
Cole National
Cooper Lavoratories
Electronic Memories & Magnetics
Fuqua Industries
Garcia Corp.
Giddings & Lewis
Great Northern Paper
Grow Chemical
*ICN Pharmaceuticals
Kysor Industrial Corp.
MacAndrews
Mesa Petroleum
Motch & Merrywheater Mach.
Oneida Limited
Phoenix Steel
Pioneer Foods Industries
Pogo Producting
Robintech
Russel Stover Candies
Seagrove Corp.
Sears Industries
Southern Industries
Sprague Electric
Texas International
Tobin Packing
Tonka
United Food Inc.

APPENDIX TABLE B.

Distribution of 300 - Company Sample,
By Size of Sales, 1977

Industrial Class	Number of Components, By Size (Sales, Millions of Dollars)			Total Number	Total Sales ($ Millions
	Under 2.5	2.5 to 100.0	Over 100.0		
Products with Workplace Import					
1. Machinery, industrial	10	10	10	30	4,684
2. Grinding wheels, industrial	10	10	5	25	8,176
3. Ferrous and non-ferrous metal castings	10	10	10	30	21,364
4. Chemicals, industrial	10	10	10	30	12,807
Products With Consumer Impact					
5. Aircraft components	10	10	10	30	11,492
6. Automotive components	10	10	10	30	4,516
7. Medical devices	10	10	10	30	10,211
8. Pharmaceuticals	10	10	9	29	8,382
9. Power Lawnmowers	10	10	1	21	
Other Products	10	10	25	45	4,813
Total	100	100	100	300	91,792

Source: Compiled by BRIMMER & COMPANY from data in Dun & Bradstreet, *Million Dollar Directory*, 1978.

APPENDIX TABLE C.

VALUE OF SHIPMENTS FOR
SELECTED MANUFACTURING INDUSTRIES, 1977
(AMOUNTS IN MILLIONS OF DOLLARS)

INDUSTRY		S.I.C. CODE	SALES
Group 1: Industrial Machinery			
1.	Construction Machinery & Equipment	3531	10,790
2.	Farm Machinery & Equipment	3523	9,200
3.	Refrigeration & Heating Equipment	3585	8,115
4.	Pumps & Compressors	3561, 3563	5,310
5.	Oilfield Machinery	3533	3,700
6.	Special Dies, Tools, Jigs & Fixtures	3544	3,567
7.	Steam, Gas & Hydraulic Turbines	3511	2,911
8.	Switchgear	3613	2,880
9.	Ball & Other Roller Bearings	3562	2,530
10.	Industrial Controls	3622	2,500
11.	Mining Machinery	3532	2,005
12.	Food Products Machinery	3551	1,840
13.	Transformers	3612	1,790
14.	Machine Tools, Metal Cutting	3541	1,620
15.	Perishable Cutting Tools	3545	1,500
16.	Process Control Instruments	3823	1,480
17.	Noncurrent-Carrying Wiring Devices	3644	1,365
18.	Power Boilers	34433	1,310
19.	Welding Apparatus	3623, 3549	1,300
20.	Printing Trades Machinery	3555	1,194
21.	Selected Industrial Pollution Control Equipment	35645, 35646	1,068
22.	Textile Machinery	3552	1,056
23.	Industrial Heating Equipment	3567	644
24.	Machine Tools, Metal Forming	3542	620
25.	Foundry Machinery & Equipment	3559	272
Group 3: Ferrous and Nonferrous Metal Castings			
1.	Steel	3312; 3315; 3316; 3317	38,051
2.	Aluminum	3334; 3353; 3354; 3355; 3361; and parts of 3341, 3399 and 3463	13,339
3.	Steel Casting	3325	11,645
4.	Primary Smelting & Refining of Lead	3332	1,200
5.	Primary Smelting & Refining of Zinc	3333	500

APPENDIX TABLE C. (CONTINUED)

INDUSTRY	S.I.C. CODE	SALES
Group 4: Industrial Chemicals: Organic & Inorganic		
1. Industrial Organic Chemicals	2869	21,800
2. Industrial Inorganic Chemicals	2819	7,646
3. Fertilizer, Phosphatic	2874	3,150
4. Pesticides	2879	2,900
5. Fertilizer, Nitrogenous	2873	2,175
6. Alkalies & Chlorine	2812	1,900
7. Inorganic Pigments	2816	1,200
8. Carbon Black	2895	460
Group 5: Aircraft Components		
1. Aircraft	3721	15,154
2. Aircraft Engines & Parts,	3724	
Space Propulsion Units & Parts	3764	7,503
3. Aircraft Equipment	3728	4,969
Group 6: Automobile Components & Tires		
1. Automobiles	3711	47,000
2. Truck & Bus Chassis	37112, 3	19,800
3. Tires & Inner Tubes	3011	10,200
4. Truck & Bus Bodies	3713	2,255
5. Truck Trailers	3715	1,600
Group 7: Medical Devices		
1. Surgical Appliances & Supplies	3842	2,710
2. Surgical & Medical Instruments	3841	2,180
3. X-Ray Apparatus & Tubes	3693	1,290
4. Optical Instruments & Lenses	3832	1,040
5. Dental Equipment & Supplies	3843	905
Group 8: Pharmaceuticals		
1. Drugs & Pharmaceuticals	283	13,350
Group 10: Other Industries		
1. Meat Packing Plants	2011	38,228
2. Paper & Paperboard	--	22,000
3. Softwood Plywood	24361 & 2	18,400
4. Commercial Printing	2751, 2, 4	14,600
5. Electronic Systems & Equipment	3662	13,500
6. Newspapers	2711	13,400
7. Converted Paper & Paperboard	264	12,140
8. Household Appliances	363	10,090
9. Bread & Other Bakery Products, Except Cookies & Crackers	2051	9,342

APPENDIX TABLE C. (CONTINUED)

	INDUSTRY	S.I.C. CODE	SALES
	Group 10: Other Industries (continued)		
10.	Sawmills & Planing Mills	2421	9,800
11.	Household Furniture	251	9,565
12.	Plastics Material & Resins	2841	9,000
13.	Photographic Equipment & Supplies	3861	8,898
14.	Guided Missiles, Space Vehicles & Space Vehicle Equipment	3769	8,820
15.	Sausages & Other Prepared Meat Products	2013	8,142
16.	Metal Cans	3411	8,000
17.	Fiber Boxes	2653	7,125
18.	Ready-Mixed Concrete	3273	6,900
19.	Malt Beverages	2082	6,865
20.	Telephone & Telegraph Equipment	3661	6,845
21.	Canned Fruits, Vegetables, Preserves, Jams & Jellies	2033	6,782
22.	Drawing & Insulating of Nonferrous Wires	3357	6,650
23.	Poultry Dressing Plants	2016	6,121
24.	Paints & Allied Products	2851	6,075
25.	Toiletries	2844	5,940
26.	Soaps & Detergents	2841	5,920
27.	Fabricated Structural Metal Products (For Buildings and Bridges)	3441	5,660
28.	Consumer Electronics	3651	5,475
29.	Valves & Pipefittings	3494	5,450
30.	Plastics Packaging Bags, Except Textile Bags	26432, 27512 and 30794	5,145
31.	Elevators, Conveyors, Hoists & Industrial Trucks	3534, 5, 6 and 7	4,780
32.	Cyclic Intermediates	2865	4,690
33.	Rolling, Drawing & Extruding of Copper	3351	3,950
34.	Motors & Generators	3621	3,937
35.	Glass Containers	3221	3,800
36.	Nonrubber Shoes & Slippers	314	3,620
37.	Frozen Specialties	2038	3,263
38.	Lighting Fixtures & Equipment	3645, 6, 7 and 8	3,250
39.	Hydraulic Cement	3241	3,125
40.	Mobile Homes	2451	3,100
41.	Frozen Fruits, Juices & Vegetables	2037	3,089
42.	Industrial Fasteners	3452	3,050
43.	Cookies & Crackers	2052	2,936
44.	Pulp Mills	2611	2,723

APPENDIX TABLE C. (CONTINUED)

INDUSTRY	S.I.C. CODE	SALES
Group 10: Other Industries (continued)		
45. Manifold Business Forms	2761	2,672
46. Concrete Products	3272	2,600
47. Distilled Liquors, Except Brandy	2085	2,411
48. Sporting Goods	3949	2,186
49. Games & Toys	3944	2,107
50. Synthetic Rubber	2822	2,100
51. Folding Paper Boxes	2651	2,095
52. Engineering & Scientific Equipment	3811	1,935
53. Current Carrying Wiring Devices	3643	1,860
54. Precious Jewelry	3911	1,835
55. Wines & Brandy	2084	1,790
56. Screw Machine Products	3451	1,770
57. Prefabricated Wood Buildings & Components	2452	1,700
58. Concrete Block & Brick	3271	1,500
59. Hose & Belting	3041	1,500
60. Leather Tanning & Finishing	3111	1,390
61. Plumbing Fittings, Brass Goods	3432	1,325
62. Phonograph Records	3652	1,300
63. Flat Glass	3211	1,200
64. Automatic Environment Controls	3822	1,140
65. Poultry & Egg Processing	2017	994
66. Other Measuring & Controlling Devices	3829	960
67. Costume Jewelry	3961	945
68. Motorcycles, Bicycles & Parts	3751	935
69. Calculating & Accounting Machines	3574	762
70. Plastic Tableware	30797	690
71. Glass Tableware	32291	660
72. Metal Sanitary Ware	3431	650
73. Luggage	3161	525
74. Small Arms	3482	501
75. Small Arms Ammunition	3484	500
76. Vitreous China Plumbing Fixtures	3261	500
77. Women's Handbags & Purses	--	435
78. Dolls	3942	420
79. Silverware	3914	405
80. Personal Leather Goods	3172	380
81. Leather- & Sheep-Lined Clothing	2386	315
82. Leather Gloves & Mittens	3151	165
83. Chinaware	3262	102
84. Earthenware	3263	85
TOTAL		704,525

Source: Compiled by BRIMMER & COMPANY from U.S. Department of Commerce, U.S. Industrial Outlook, 1978, Appendix A, pp. 465-468.

APPENDIX TABLE D.

Manufacturers' Sales (Shipments), By Major Industry Group, 1976 (Millions of Dollars)

Industry	Amount
Total	1,178,013
Durable Goods: Total	604,514
Stone, clay, and glass products	30,435
Primary metals	88,826
Blast furnaces, steel mills	45,137
Nonferrous and other primary metals	34,110
Fabricated metal products	79,659
Machinery, except electrical	109,652
Electrical machinery	72,039
Transportation equipment	135,223
Motor vehicles and parts	91,115
Instruments and related products	24,905
Nondurable Goods: Total	573,498
Food and kindred products	176,150
Tobacco products	8,087
Textile mill products	37,583
Paper and allied products	50,227
Chemical and allied products	101,385
Petroleum and coal products	82,640
Rubber and plastic products	32,572

Source: U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business, April, 1978, pp. S-5 and S-6.

APPENDIX TABLE E.

Product Liability Rates

For Target Product Categories

Calculations reflect basic limits rates and increased limits factors up to a limit of liability of $500,000 for both bodily injury and property damage. Rates do not reflect application of experience or schedule modifications.

1. INDUSTRIAL MACHINERY	ISO Product Code	Estimated Average Rate as a Percentage of Sales*
Tools - dies, jigs & fixtures (Mfg)	35401	.52%
Metal working machinery & equipment (Mfg)	35402 (a)	3.12
Hand tools - powered	35202 (a)	2.70
Const, mining & mat'l. handl.	35302 (a)	1.70
Ind. mach. & equip. (NOC)	35500 (a)	2.90
Machinery (Mfg)	35992 (a)	2.90
Elec. gen. equip. (Mfg, NOC)	36102 (a)	1.10
Elec. equipment	36202 (a)	1.73
Engines & turbines	35100 (a)	1.10
2. INDUSTRIAL GRINDING & ABRASIVE PRODUCTS		
Abrasive wheels	32902 (a)	1.42
Abrasives (Mfg, NOC)	32908 (a)	.30
3. FERROUS & NONFERROUS METAL CASTINGS		
Metals - smelt. or refin. (Mfg)	33300 (a)	.17
Struc. iron & steel - excl. erection (Mfg)	33101 (a)	.39
Metals - proc. - no fab. metal proc. manufactured (Mfg)	34702 (a)	.37

* a) Rates shown on this list are based on the results of our underwriting file analysis supplemented by underwriters' estimates of average rates.

4. INDUSTRIAL CHEMICALS - ORGANIC & INORGANIC	ISO Product Code	Estimated Average Rate as a Percentage of Sales
Chemicals - inc. use (Mfg, NOC)	28105 (a)	1.35
Chemicals (Mfg, NOC)	28905 (a)	.73
Chemicals - Herbicides (Mfg)	28703 (a)	1.58
Chemicals - Pesticides (Mfg)	28702 (a)	1.58
Gases - in drums (Mfg, NOC)	28102 (a)	(1.88 per number of filings)
Gases - in steel - cyl. (Mfg, NOC)	28107 (a)	(.48 per number of filings)
Gases - in tank cars (Mfg, NOC)	28108 (a)	(6.18 per number of filings)
Dry ice (Mfg)	28103	.13
5. AIRCRAFT COMPONENTS		
Airplane wheels	37201 (a)	N/A
Aircraft Mfg.	37202 (a)	N/A
Aircraft engines	37203 (a)	N/A
Radio, TV, sound systems	36511	.06
Elect. components	36703 (a)	Insufficient data
Control instruments	38200 (a)	Insufficient data
Instruments (NOC)	38110 (a)	Insufficient data
Computers	35701 (a)	Insufficient data
TV picture tubes	36701	.44
Household TV	36512	.06
6. AUTOMOBILE COMPONENTS AND TIRES		
Auto, bus, truck accessories, not operating parts (Mfg)	37105	.42
Autos, buses, trucks (Mfg)	37101 (a)	.56/3.56
Auto bodies - excl. trail. (Mfg)	37102 (a)	.92
Auto, bus, truck brake lin. (Mfg)	37103 (a)	1.24
Auto, bus, truck inner tubes (Mfg)	30112	(.37 per number tubes)
Camper & trailer bodies	37113 (a)	1.14
Safety belts	37116	.44
Auto acc. stores	59351	.17
Bus bodies	37112 (a)	1.34
Auto acc. stores - wholesale	50121	.17
Trailers - mobile homes (Mfg)	37990 (a)	1.30
Truck bodies	37114 (a)	1.40
Auto parts (NOC)	37115 (a)	2.10
Batteries - storage (Mfg)	36902	.23
Batteries - dry (Mfg)	36901	.53
Motor vehicles (personal) (Mfg)	37111 (a)	1.44
Tires - auto, bus, truck	30111	(.52 per number tires)
Tires - recap	75301	(13.11 per number tires)
Engines & turbines	35100 (a)	.90

7. MEDICAL DEVICES	ISO Product Code	Estimated Average Rate as a Percentage of Sales
Med, den, hosp, surg. instru., excl. equip. & diag, treat. mach. (Mfg)	38401(a)	.47
Med, den, hosp, surg. equip. non expendable (Mfg)	38402(a)	1.39
Med, den, hosp, surg. supplies - expendable (Mfg)	38403(a)	.25
Med, den, or surg. diag. or treat. mach. or devices (Mfg)	38404(a)	1.79
Elec. equip. - direct & indirect applic. to body (Mfg, NOC)	36402	1.41
Instr. - analy, calib, measur, testing or recording (Mfg)	36101(a)	.72
8. PHARMACEUTICALS		
Drugs, medicines, phar. prod. (Mfg) animal use only (NOC)	28301(a)	2.35
Drugs, medicines, phar. prod. (Mfg, NOC)	28302(a)	.57
Drugs - ground prod. (Mfg)	28303(a)	.48

STATEMENT OF ROBERT CLEMENTS, EXECUTIVE VICE PRESIDENT, MARSH & McLENNAN, INC., NEW YORK, N.Y., ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE BROKERS (NAIB)

SUMMARY OF PRINCIPAL POINTS

NAIB strongly supports (1) deductions for reasonable amounts set aside for self-insurance reserves for product liability losses and expenses and for amounts paid to related domestic and foreign insurance companies or "captives"; and (2) the Administration's proposal to extend to ten years the net operating loss carryback for product liability losses. Both should be enacted.

In addition, deductions should be available with respect to professional liability losses and expenses.

Deductions for self-insurance should be limited by a standard of reasonableness, *i.e.*, to what is actuarially sound. The deductions will be of no significant benefit if they are restricted to arbitrary limits.

Thank you, Mr. Chairman.

I am Robert Clements, Executive Vice President of Marsh & McLennan, Incorporated. I am accompanied by counsel, Mr. Jerry L. Oppenheimer, of Mayer, Brown & Platt of Washington, D.C. We appear here today on behalf of The National Association of Insurance Brokers, the association of the nation's leading commercial insurance brokers and agencies, whose clients include most of the major industrial and institutional consumers of insurance in the United States.

The members of NAIB provide a broad spectrum of essential services to clients in areas of risk reduction, risk management and protection against economic loss, including placement of the bulk of commercial property and casualty insurance required by such major risks. Our fundamental purpose is to consult with businesses of all sizes on the best and most economical means of protecting against all types of risk arising from the conduct of a business enterprise.

I. INTRODUCTION

We welcome the opportunity to appear here today, and we applaud you for holding these most important hearings. NAIB strongly supports the concepts embodied in the legislation now pending before your Subcommittee to provide businesses at all levels alternative means of relief from the rapidly escalating costs of product liability insurance and the potential financial crisis courted by businesses which cannot afford, and in some cases cannot obtain, adequate insurance protection.

The proposals to amend the Internal Revenue Code fall into three categories: (1) those permitting deductions for amounts set aside in self-insurance reserves to meet future claims; (2) those clarifying the allowance of deductions for amounts paid to related insurance companies, or "captives;" and (3) the Administration's proposal to extend to ten years the net operating loss carryback for businesses which suffer product liability losses.

All of these proposals have significant merit. While we expect that insurance obtained in the private market will continue to meet most of industry's product liability needs, as it does now, NAIB believes present circumstances demand that all reasonable options and alternatives to achieve the goal of economic protection ought to be available. Deductions for self-insurance reserves and for amounts paid for insurance protection afforded by captives will ease the problems confronting some businesses. Extending the loss carryback will be helpful in certain cases. We endorse each of these propositions as reasonable and desirable partial solutions to a very difficult and complex problem. We believe they meet the test of the public interest. We urge that legislation embodying these proposals be adopted. Further, we strongly recommend extension of these measures to embrace all forms of professional liability as well as product liability; the liability arising from professional malpractice is essentially the same as a "product liability" loss in that the "product" of a professional is the service provided which may give rise to such liability.

II. IS THERE A "CRISIS"?

While some have continued to debate whether or not there is a "crisis" today in product and professional liability, that is academic; there is a severe and continuing problem. It is painfully well known to those businesses it has hit the

hardest; and it has been amply documented in the report of the Interagency Task Force on Product Liability, the Options Paper of the Department of Commerce, and a report of the Subcommittee on Capital, Investment and Business Opportunities of the House Committee on Small Business.

The total available market capacity falls short of delivering the limits of liability considered adequate for the needs of many businesses, particularly smaller and high risk enterprises. Even those businesses which can obtain product liability insurance find that premiums have become extremely burdensome; there is a point at which the high cost of insurance can make it virtually unavailable to a business. Such businesses should have a viable option to self-insure potential losses.

Businesses, most particularly the smaller businesses, need immediate relief. Without it, the problem will worsen to the detriment of the public which needs assurance of economic protection in the event of an injury; of businesses which can no longer afford commercial insurance; and of the nation which will lack diversity of products and services should the present situation continue. Manufacturers, suppliers, distributors, and professionals, especially smaller businesses, which can no longer afford the risks of such liability will curtail or suspend their operations. Or perhaps worse, they will continue to operate without insurance and with insufficient assets to indemnify injured parties.

III. THE FUNDAMENTAL OBJECTIVE

While the pending legislative proposals are a response to the extreme difficulties encountered by small businesses in the purchase of insurance, the primary objective of "tax equity" is not merely to provide tax relief. The ability to expense a reserve is no substitute for insurance; it is merely a device to recognize that where insurance is not required (because the amount to be self-insured is financially bearable) there ought to be some provision to deduct the amounts set aside to pay anticipated losses. That is a reasonable and justifiable premise in itself, especially since insurance companies enjoy that same privilege now. But the real objective of the proposal is to make insurance available at reasonable cost to small busineses. The shortage of insurance is largely attributable to lack of underwriting capacity in the insurance industry, and "tax equity" is a device designed to restore the balance between the supply of coverage and the demand for it, by reducing the demand.

Present tax laws work to create an incentive to purchase insurance beyond that actually needed for risk protection reasons, by favoring the purchase of insurance over other means of achieving protection. Premiums paid for commercial insurance are currently deductible against current income; additions to self-insurance reserves are not. Income earned on reserves held by commercial insurance companies is generally exempt or tax-favored; income earned on self-insurance reserves is not. Furthermore, there is concern that funded reserves for protection against product and professional liability claims may be subject to the penalty tax on unreasonable accumulations.

Accordingly, many companies which have the capacity to self-insure are influenced by the tax provisions to purchase insurance. A deduction for self-insurance would neutralize the tax choice between conventional insurance and self-insurance; and, since the potential liability is an economic cost of doing business, tax accounting would more clearly reflect economic reality.

IV. THE PROPOSED SOLUTIONS

There are two principal problems which must be resolved. First, some means must be found to assure that injured parties are compensated for losses caused by products or malpractice of uninsured or underinsured persons. Second, a means must be found to protect uninsured or underinsured persons facing product or malpractice claims from financial ruin when claims are presented.

A. *Net Operating Loss Carrybacks.*—The Administration has proposed extending the net operating loss carryback. The tax refund arising from the increased carrybacks will provide a source of funds to pay claims and to help a previously profitable taxpayer to stay in business despite a large liability loss. The proposal's main advantage is that it will provide potential funds for these payments as soon as the legislation is passed, without having to wait, for example, for reserve funds to accumulate.

On the other hand, increased loss carrybacks would have little value for new businesses or for businesses which have paid little tax, such as those which have

been only marginally profitable. Smaller businesses frequently fall into this category. Furthermore, loss carrybacks may negate investment tax credits which are frequently claimed by expanding businesses. Taxpayers might merely trade tax credits for tax losses with no net benefit. A common complaint of small businessmen is the complexity of tax returns, and a new provision such as extending the carryback period, which requires complex calculations and possibly professional advice, would exacerbate such complaints.

NAIB is also concerned about the "immediacy" of the available cash. A tax refund could not be obtained until a return is filed and processed which would normally be significantly after a claim is determinable. In addition, extending the carryback period will not increase incentives for loss prevention and will not satisfy the requirements that the businessman show he has the requisite insurance to receive an order or to bid on a contract. In summary, NAIB endorses the proposal to extend the carryback period to ten years as a partial answer to the problem, but an extended carryback cannot be relied upon as the total solution.

B. *Self-Insurance.*—Many businesses faced with the problem of inadequate insurance protection have been forced to self-insure. The two bills before the Subcommittee would attempt to achieve tax equity by permitting deductions for contributions to funded self-insurance reserves. NAIB strongly endorses this approach. Deductions may be beneficial even where businesses are only marginally profitable. The funded reserve will provide monies to pay claimants and assure business continuation. Because the funds are the taxpayer's, loss prevention is fostered. In addition, funded reserves for self-insurance often satisfy commercial or contract requirements that the businessman be insured. The self-insured taxpayer also gains control over the handling and settling of claims and lawsuits.

We submit, however, that deductions for self-insurance should be limited only by a standard of reasonableness, i.e., to that which is actuarially sound, as opposed to adoption of arbitrary limits as is proposed in the bills before the Subcommittee. We recognize that fixed dollar and percentage of receipts limitations were introduced to limit abuse of the set-aside opportunity, but both approaches create problems as now designed. The dollar limitations are so confining as to render the proposal nearly useless as a device to increase availability of coverage. On the other hand, the percentage limitations are so liberal that it is hard to imagine they will have any practical effect. Better safeguards can be designed, and simplicity of monitoring such funds would be better served, if, for example, a more realistic gross receipts percentage maximum were adopted which included a scaled reduction with each excess increment of sales, and third party authentication were to be required from an accountant or actuary.

C. *Captive Insurers.*—NAIB also strongly supports clarification that amounts paid to captives are deductible and strongly opposes as unwarranted and unrealistic the suggestion that deductions should be limited to amounts paid to domestic captives.

Captive insurers present a viable alternative to commercial insurance and have been rapidly gaining in popularity. Generally, a captive is an insurance company wholly owned by a single company or by an association or group of similarly situated companies. Captives are generally organized offshore, although Colorado and Tennessee encourage them, and other State regulatory agencies are studying measures to foster them.

Captives afford advantages of providing funds to pay claims and assure business continuation. They result in reduced operating costs. Loss prevention is encouraged since both the premiums and the profits of the captives are dependent on minimizing claims paid. Defendants also control lawsuits and claims handling.

Captives present certain advantages over self-insurance. By providing direct access to reinsurance markets they contribute to more efficient use of available insurance capacity. They, themselves, create additional capacity by their existence. Further, for many corporations a captive provides a more efficient means of risk management than self-insurance through the use of generally accepted accounting principles. Association and group captives also pool premiums and would generally have sufficient funds to satisfy larger claims much sooner than funded self-insurance reserves generally could.

The status of captives under the Code, however, has been and continues to be under challenge by the Internal Revenue Service. A ruling last year held that premiums paid to wholly owned offshore captives were nondeductible capital contributions, and claims payments were dividends or return of capital. The status of domestic captives and association or group captives is less than certain. Favorable clarification of the status of captives would foster their growth and greatly contribute to the goals of the bills under consideration.

V. LOSS OF TAX REVENUE

It has been argued by opponents of the alternative protection devices that equitable tax treatment for self-insurance programs and captives will adversely affect federal tax revenue. Opponents have argued that captives can lead to increased insurance costs because they lack the pooling of risks common to other insurance ventures. An objective of a single-owner captive is to provide a means of funding and administering that portion of the owner's risk which he is able to absorb himself and does not need to transfer to a conventional insurer. To the extent that the use of captives is inhibited by regulatory and federal income tax considerations, risks are transferred unnecessarily to the conventional insurance market. This results in a wasteful increase of demand on an insurance market already suffering from limited capacity. Further, it is demonstrable that captives lead to a reduction of the overall cost of insurance, not an increase.

The concern expressed that structured self-insurance programs will reduce federal tax revenue is equally unfounded. There is reason to believe that deductibility of payments to structured self-insurance programs can produce an increase in tax revenue. As we have said, present tax laws influence the purchase of unneeded insurance for tax reasons, especially in product liability in the case of "long tail" businesses where an insured can take tax deductions for premiums years before he could acknowledge payment of an uninsured loss.

On the other hand, the amount contributed to a self-insurance fund should consistently average in the area of 25 percent less than the amount necessary to secure conventional insurance for an equivalent risk. Since the deductibility of such contributions would lead to a significant increase in the practice of self-insurance, and a corresponding decrease in the purchase of conventional insurance, the result to be expected is an increase in corporate profits, with attendant benefit to both federal and state tax revenues. This would be offset only partially by a reduction in corporate tax revenue where credit is given for risks already self-insured.

VI. CONCLUSION

The thrust of the pending legislation is to provide equitable tax treatment for additional avenues of economic protection against product liability loss, thereby making these alternatives to the purchase of insurance in the private market available to persons who need such alternatives. The term used to describe this legislation—"Tax Equity"—is most appropriate in that it seeks only to provide a self-insured, whether through a reserve or a captive, similar tax treatment to that which is available to an insurance company, and for amounts paid to an insurance company.

We endorse the conclusion of the Federal Interagency Task Force Report that adverse contingencies should be funded with pre-tax dollars. In support of that, we would like to make the point that insurance companies are permitted to fund such contingencies with pre-tax dollars, and the denial of a similar right to non-insurance companies could be viewed as unfairly and unreasonably discriminatory. The tax law, as currently administered by the Internal Revenue Service, in effect, so strongly favors the insurance underwriting business that it makes it the "only game in town" for a businessman seeking tax deductibility for monies spent for the necessary protection of his business.

The Code should be neutral and should not make arbitrary distinctions between deductions for funded reserves and for amounts paid to captives, or between foreign and domestic captives. We urge most strongly your favorable consideration to produce that end.

The foreging comments do not deal with technical problems presented by the two bills before the Subcommittee. We would appreciate the opportunity to answer your questions, to amplify this statement through supplemental submissions, to confer with members of the Subcommittee and its staff, and generally to make the experience of NAIB's members, staff and counsel available to the Subcommittee.

STATEMENT OF THE SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. Charman and Members of the Subcommittee: My name is Anthony Schopp and I am Executive Vice President of the Machinery Dealers National Association (MDNA), a national trade association whose 400 members are primarily

small, family-owned companies employing ten to twenty people, with total industry sales of just under one billion dollars.

I am appearing today on behalf of the Small Business Legislative Council (SBLC), an organization of national trade and professional associations whose members are predominantly smaller businesses. The SBLC focuses on issues of common concern to the entire small business community and today represents approximately four million small business firms nationwide. The SBLC has adopted the position, supported by 40 national associations, that smaller manufacturers need immediate relief if they are to survive the current product liability crisis. (See Attachment.) The self-insurance concepts embodied in the bills, S. 1611 and S. 3049 (as well as in other similar legislation in both the House and Senate), would provide that relief, without foreclosing more substantive reform in the law at the Federal and State levels.

Within recent years, there has been an explosion of litigation in the medical malpractice and product liability areas. The result of the increasing numbers of cases and the large judgments awarded to plaintiffs in these cases has been a corresponding explosive increase in product liability insurance rates. Many manufacturers have experienced increases in their premiums of 1,000% and some increases have been much larger. A growing number of companies find that product liability insurance is unavailable at any price, even after 15 or 20 years without a claim against them.

While it is obvious that the increase in product liability and the consequent increase in insurance rates affects businesses of all sizes, small business in general is least able to bear the impact of this development.

The small manufacturer who cannot obtain product liability insurance from any source at any price is faced with two choices—go "naked" (i.e., remain uninsured), or go out of business. In certain cases, he does not have even this choice, as distributors, wholesalers, or other buyers of his product can refuse to handle his goods without proof that he is insured. This may be particularly true if his product is a component of another, and the manufacturer of the finished product is also under product liability pressure. A further example would be the manufacturer of a product, such as a cleaning fluid, who finds retailers will not put the product on the shelf until the manufacturer can show proof of product liability insurance coverage.

The manufcaturer who chooses to go "naked", even if he can find people to handle his goods, may have great difficulty obtaining loans or other credit or financing, because of the unlimited contingent liability against his company's assets that going uninsured entails.

Many representatives of the insurance industry have contended in recent months that the problems of manufacturers obtaining product liability coverage just do not exist—that coverage is widely available to those seeking it. From the evidence received by the membership of the Small Business Legislative Council's member associations, we find this simply not to be true. Consider, if you will, the following excerpts from letters received by the National Small Business Association (NSB), a national trade association representing 50,000 small business firms. A New Jersey company writes:

"I would like to take this opportunity to call to your attention a growing problem which has recently affected us * * *. I refer to the growing refusal on the part of insurance carriers ot either offer or renew comprehensive liability and products liability insurance. Our company, for example, has paid out over $60,000 in premiums over the past five years and during this period of time there have ben no claims for which the insurance company has paid out any losses * * *. Notwithstanding this record, we have received word from our former carrier, (company name), that our workmen's compensation insurance, and our comprehensive general liability policies were cancelled effective May 30, 1978. We have diligently attempted to obtain coverage with other carriers, but to date have not been successful * * *."

From a small metalworking company in California, NSB received this product liability story:

"Our products are superior in every way, with absolutely no built-in obsolescence. We believe in genuine quality, and our products are virtually handcrafted. Our small crew machines all the pieces, welds the respective components, and hand-assembles the finished parts * * *. Yet, despite our excellence, we are unable to acquire any product liability insurance. Even our insurance broker says the quotes are astronomical and ridiculous. Whereas, before the current ir-

rationality, our company could have expected to pay about $1,500 annual premium on $500,000 coverage, now it is more like $7,000 to $10,000 annual premium, on only $100,000 coverage * * *. Of course, going "bare" as we are, like so many other small manufacturers, it definitely narrows and, in some instances, curtails our distribution system. For instance, the large and famous distributors will not handle our products unless we (1) carry sufficient product liability and (2) name them as vendors. This means that we have already lost Sears Roebuck, J.C. Penney, and Kelley-Moore. This represents a loss to us in prospective sales of untold thousands of dollars worth of business a year * * * if large distributors of goods refuse to represent us without insurance coverage, then what assurance is there that smaller distributors will not eventually cease to do business with us on the same grounds? * * *"

A large company in the same situation is in much less of a dilemma. Many larger companies have reached to the soaring rates of liability insurance by buying or establishing "captive" insurance companies (i.e., insurers that are owned or controlled by the larger parent, and can supply insurance for that parent exclusively). A company wih a "captive" insurance company can take advantage of the same tax advantages applicable to any insurance transaction (i.e., deductibility of premium payments), but can also (by virtue of its control over the insurer) control the rates and/or losses of the insurance company. A "captive" insurer which does not write insurance for any outside company would not, of course, be affected by judgments or expenses involved in suits against anyone other than the parent company and is thus somewhat sheltered from the overall increase in product liability costs spread across an entire industry.

Even if a larger company decides to go "naked", it is much more able to cope with the problems this creates. A large company relies less on debt capital than a smaller company, and thus avoids the problems faced by smaller manufacturers who go "naked" and then seek loans. A large company is also better able to absorb the legal costs of product liability suits, and possible judgments, as its cash reserves and other resources are likely to be more extensive. The large company would rarely be forced out of business by product liability claims, even if it is uninsured.

Where insurance is available, but only at a very high cost (often greater than the gross sales of the company), the "smalls" are similarly disadvantaged. Lacking excess cash to meet the higher premium, the smaller company is also less able to pass the cost through to his customer, or to spread the cost over an entire line of products.

With this in mind, we would like to address the inflationary impact of the product liability crisis. When faced with increasingly higher premium costs, smaller manufacturers often must pass this along to their customers in forms of higher prices. In highly-competitive industries, as we have noted, the small company suffers a severe marketplace handicap. In one particular instance recently brought to our attention, a manufacturing company in Oregon added to a farm implements invoice a "Product Liability Insurance Surcharge" of 6% of the sales price of the product!

A small company in Michigan, in public hearings before the Michigan House Economic Development Committee, commented extensively on the product liability problems it was experiencing, and how these problems affected sales and day-to-day business operations. Its President has written:

"Product Liability has become one of the most serious problems affecting our business. In 1975, our premiums for Liability coverage were under $16,000. In 1976, the insurance company who carried us since 1939, informed us they would not renew our policy. After much trouble, we found a company that would write us at a cost of over $72,000. We had to make short term borrowings to finance these premiums. This year we were told that the insurance company would not renew our policy at any cost. After searching desperately, we were reinsured by our original carrier at a premium cost estimated to be in excess of $100,000! This is a 625% increase in two years! * * * Even though we presently have coverage, serious problems still remain. We are in a highly competitive business and find it almost impossible to pass on this type of cost increase to our customers. Our borrowing capacity is stretched to the limit and dollars that should be going back into the business to improve our plant and equipment and to create new jobs are of necessity being spent in insurance premiums * * *. Three companies in our industry cannot get insurance *at any price* even though two of them have never had a single claim filed against them. They are presently

'running bare' with the threat of a single suit that could wipe out along with the loss of all their employees' jobs. I know of many small businesses that are facing similar problems * * *."

The causes of the increase in product liability suits are many. Relatively recent changes in tort law governing the area (making it much easier to pursue a successful suit against the manufacturer and distributor of a product) are largely responsible for the upsurge in product liability litigation, but other factors, such as the increasing cost of medical care and the relatively low level of State-administered Workers' Compensation awards, have also contributed to the problem.

While a solution to the product liability problem lies ultimately in statutory or judicial changes in the tort law of product liability, the immediate and serious problems of the manufacturer and distributor seeking to obtain some type of protection against this liability demand an interim solution.

One approach highly favored by the membership of the Small Business Legislative Council is the self-insurance concept provided for by the bills under consideration today. S. 1611 and S. 3049, the "Product Liability Self-Insurance Act of 1978", would amend the Internal Revenue Code of 1954 to allow a manufacturing, leasing, importing or distributing company to self-insure against risk by establishing a reserve fund in trust, subject to the same tax-deductible provisions currently governing insurance premiums paid by business.

There are many advantages to the small business under the self-insurance approach advocated by the sponsors of these bills. Self-insurance offers to those small firms unable to obtain insurance at an affordable premium the chance to self-insure against all or part of their liability risk. There is flexibility in the self-insurance proposals, allowing a small business owner to choose the amount of self-insurance—insuring for the entire amount, or opting to purchase (where available) regular liability coverage at a higher deductible. In both cases, the small company would enjoy the tax benefits that accrue to purchasers of business liability coverage.

The Commerce Department's recently-announced proposals to aid small businesses suffering from product liability claims, while commendable in that they indicate the Administration's formal recognition of the economic consequences of the product liability crisis, do not address the most pressing problems facing small business in the area of product liability.

The Administration has proposed amending the Internal Revenue Code to extend the loss carryback period to 10 years from the present three, thereby allowing a small business facing a liability claim to recoup that loss from refunds of previous years' taxes.

The proposal, intended to offer an immediate relief for small businesses confronting large settlements, treats only this most visible part of the problem and ignores what we see as the more damaging aspects of product liability—the sky-rocketing costs and increasing unavailability of liability coverage for small firms. The Administration's proposal does not deal with business' difficulty in obtaining product liability insurance at a reasonable cost; it helps only those already hit by claims. It is, in essence, an after-the-fact remedy.

Since smaller manufacturers rarely would have the cash or other reserves needed to meet a large liability judgment, the proposal will be of benefit only to those small firms which can fully take advantage of it. This, of course, means that the company in question would have to have had sufficient taxable profits in the preceding ten years. Our concern is for the companies that may have a horrendous judgment against them. For these companies, the Administration's proposal will not be of adequate help. They may have folded already!

Although the Small Business Legislative Council supports wholeheartedly the self-insurance proposals embodied in S. 1611, S. 3049, and other similar legislation in both Houses, as the most viable short-term relief for small companies unable to afford or obtain product liability coverage, self-insurance would, in our view, complement the proposals of the Administration. While the Administration's extension of the carryback period would help those small businesses already faced with large liability judgments, the self-insurance proposals would offer to many small businesses the flexibility they desperately need to maneuver their companies around unaffordable and unobtainable product liability coverage.

The small companies whose existence is threatened now by the product liability situation cannot afford to wait years for the picture to change. They

need immediate relief. By allowing smaller companies that cannot obtain coverage from insurance companies to protect themselves against the potentially catastrophic results of product liability litigation, the small business community would receive that relief.

The SBLC urges this Committee's adoption of this unique approach to a grievous problem for small business.

Forty associations support the self-insurance approach to product liability problems. These associations believe that small business needs immediate relief if it is to survive the current product liability crisis. The self-insurance approach helps provide that relief, without foreclosing more substantive reforms in the law at the federal and state levels. These associations are:

American Association of Nurserymen, Washington, D.C.
Association of Steel Distributors, Cleveland Ohio.
Automotive Warehouse Distributors Association, Inc., Kansas City, Missouri.
Building Service Contractors Association International, McLean, Virginia.
Christian Booksellers Association, Colorado Springs, Colorado.
Direct Selling Association, Washington, D.C.
Electronic Representatives Assoc., Chicago, Illinois.
Food Merchandisers of America, Inc., Washington, D.C.
Independent Bakers Association, Washington, D.C.
Independent Sewing Machine Dealers of America, Inc., Hilliard, Ohio.
International Franchise Association, Washington, D.C.
Local and Short Haul Carriers National Conference, Washington, D.C.
Machinery Dealers National Association, Silver Spring, Maryland.
Manufacturers Agents National Association, Irvine, California.
Marking Device Association, Evanston, Illinois.
Menswear Retailers of America, Washington, D.C.
Narrow Fabrics Institute, Inc., New Rochelle, New York.
National Association for Child Development & Education, Washington, D.C.
National Association of Black Manufacturers, Washington, D.C.
National Association of Brick Distributors, McLean, Virginia.
National Association of Catalog Showroom Merchandisers, New York, New York.
National Association of Home Manufacturers, Washington, D.C.
National Association of Independent Lumbermen, Washington, D.C.
National Association of Plumbing/Heating/Cooling Contractors, Washington, D.C.
National Association of Realtors, Chicago, Illinois.
National Association of Retail Druggists, Washington, D.C.
National Beer Wholesalers of America, Inc., Chicago, Illinois.
National Electrical Contractors Association, Inc. Bethesda, Maryland.
National Family Business Council, Westville, New Jersey.
National Home Improvement Council, New York, New York.
National Independent Dairies Association, Washington, D.C.
National Independent Meat Packers Association, Washington, D.C.
National Insulation Contractors Association, Washington, D.C.
National Office Machine Dealers Association Inc., Hackensack, New Jersey.
National Office Products Association, Alexandria, Virginia.
National Paper Trade Association, Inc., New York, New York.
National Pest Control Association, Vienna, Virginia.
National Precast Concrete Association, Indianapolis, Indiana.
National Small Business Association, Washington, D.C.
National Society of Public Accountants, Washington, D.C.

STATEMENT OF THE SMALL BUSINESS LEGISLATION COUNCIL

Mr. Chairman and Members of the Subcommittee: The Small Business Legislative Council supports S. 3049 to provide American small business the chance to manage their enterprises in a logical, understandable manner during our country's economic morass which results from the product liability crisis we now experience.

My name is Anthony Schopp from Vienna, Virginia, and I am Executive Vice President of the Machinery Dealers National Association, an international trade group with 400 U.S. members operating in the after-market of the machine tool industry and supplying most of the industrial equipment used by small

manufacturers. Our members are primarily small, family-owned companies with five to fifty employees; annual industry sales are projected at just under one billion dollars.

The Small Business Legislative Council is a federation of national trade and professional associations whose members are small businesses. S.B.L.C. focuses on issues of common concern in the small business community and represents ness needs this opportunity if all are to survive the crisis that engulfs our approximately four million small companies. Our position is that small business nation today.

This position is a reluctant but very firm conclusion: the pride of American enterprise tends away from government assistance. Yet, because they want to run their businesses independently and competitively, small businessmen must urge adoption of this legislation.

Current tax law makes it easier for large businesses to establish reserves with post-tax funds not being subject to accumulated profits taxation. The proposal to allow tax credit for product liability losses would help only a limited number of corporate tax payers. Adoption of S. 3049 will sufficiently address the bad situation in which business is caught today.

Court interpretations of tort law encourage frivilous and expensive lawsuits and require defendants to prove innocence. As over-reaction by the insurance industry has produced panic pricing with liability insurance premiums now costing more than many small businesses hope to earn annually. The National Small Business Association unfortunately has an impressive collection of letters from firms throughout the country in all industries represented by the associations supporting S. 3049 (see attachment), describing simply, accurately and honestly the horror stories about the unavailability of insurance. Unavailability and nonaffordability are synonomous. Over half our Association members are forced to operate their businesses without liability coverage. This fact and others are found in a feasibility study in our consideration of setting up a captive insurance company in Bermuda. Should this occur, it will only be because there were no other alternatives to obtain insurance. Two and three years ago, many of our members who had operated their businesses for fifteen, twenty-five, thirty years without a claim paid about 50¢ per thousand dollars for product liability insurance with a small, if any, deductible. Today these firms "can" purchase insurance for 20 to 24 dollars per thousand with coverage limited to losses between $300,000 and one million dollars. Several were told they could buy $100,000 of first-dollar coverage for $100,000. Some of these offers were proposals from insurers identified in the Marketing Assistance Programs. Our members stopped attempting to acquire coverage via the MAPs concluding it was a waste of time.

For a small businessman it is more logical and reassuring to set up a loss reserve than to be told he can carry-back losses ten years rather than three. This committee realized that income effect is superior to tax effect when an enacted law permitted mining companies to establish reserves for black lung disease losses.

We prefer the deductible reserve because it will encourage improvement of prevention techniques to avoid claims against ones own money, and frankly small businesses feel the self-insurance concept is the best way to obtain fair coverage from an insurance industry which has been unreasonable in establishing premium rates.

Finally, our request is reasonable. The great majority of all small businesses do not have product liability problems because of flawed products or services. Few actions against go to court and it is highly unusual for a judgment against. But the uncontrollable and untenable situation of our present tort system produces many suits and costly litigation. For those few members who do have a catastrophic loss, the carry-back proposal will help and should be enacted. However, for the vast majority of businesses who are mostly small the deductible reserve is the best way they can continue operating reasonably during the crisis. Our goal is to remain, to paraphrase President Johnson, taxpayers not tax-eaters. Thank you.

Forty associations support the self-insurance approach to product liability problems. These associations believe that small business needs immediate relief if it is to survive the current product liability crisis. The self-insurance approach helps provide that relief, without foreclosing more substantive reforms in the law at the federal and state levels. These associations are:

American Association of Nurserymen, Washington, D.C.
Association of Steel Distributors, Cleveland, Ohio.

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Automotive Warehouse Distributors Association, Inc., Kansas City, Missouri.
Building Serivce Contractors Association International, McLean, Virginia.
Christian Booksellers Association, Colorado Springs, Colorado.
Direct Selling Association, Washington, D.C.
Electronic Representatives Assoc., Chicago, Illinois.
Food Merchandisers of America, Inc., Washington, D.C.
Independent Bakers Association, Washington, D.C.
Independent Sewing Machine Dealers, of America, Inc., Hillard, Ohio.
International Franchise Association, Washington, D.C.
Local and Short Haul Carriers National Conference, Washington, D.C.
Machinery Dealers National Association, Silver Spring, Maryland.
Manufacturers Agents National Association, Irvine, California.
Marking Device Association, Evanston, Illinois.
Menswear Retailers of America, Washington, D.C.
Narrow Fabrics Institute, Inc., New Rochelle, New York.
National Association for Child Development & Education, Washington, D.C.
National Association of Black Manufacturers, Washington, D.C.
National Association of Brick Distributors, McLean, Virginia.
National Association of Catalog Showroom Merchandisers, New York, New York.
National Association of Home Manufacturers, Washington, D.C.
National Association of Independent Lumbermen, Washington, D.C.
National Association of Plumbing/Heating/Cooling Contractors, Washington, D.C.
National Association of Realtors, Chicago, Illinois.
National Association of Retail Druggists, Washington, D.C.
National Beer Wholesalers of America, Inc., Chicago, Illinois.
National Electrical Contractors Association, Inc., Bethesda, Maryland.
National Family Business Council, Westville, New Jersey.
National Home Improvement Council, New York, New York.
National Independent Dairies Association, Washington, D.C.
National Independent Meat Packers Association, Washington, D.C.
National Insulation Contractors Association, Washington, D.C.
National Office Machine Dealers Association, Inc., Hackensack, New Jersey.
National Office Products Association, Alexandria, Virginia.
National Paper Trade Association, Inc,, New York, New York.
National Pest Control Association, Vienna, Virginia.
National Precast Concrete Association, Indianapolis, Indiana.
National Small Business Association, Washington, D.C.
National Society of Public Accountants, Washington, D.C.

Statement of Robert Friedlund, Chairman of the Product Liability Steering Committee of Material Handling Institute

I. Introduction

A. Material Handling Institute

Mr. Chairman and Members of the Senate Finance Committee: My name is Robert Friedlund and I am testifying on behalf of the Material Handling Institute, located in Pittsburgh, Pennsylvania, represents 355 material handling equipment manufacturers with headquarters throughout the country. Gross sales of MHI members for material handling equipment totalled more than 5 billion last year and they manufactured approximately 80% of the material handling equipment made in this country.

MHI members constitute a broad cross-section of the nation's business community. While 15 of its members have yearly sales of material handing equipment of over 20 million dollars, 144 of its members have yearly sales of less than $500,000. MHI is, therefore, able to present the views and problems of both large and small business.

On behalf of MHI, I wish to thank the members of the Committee for allowing us to testify. We particularly welcome the opportunity to present our views on what we consider to be a growing national crisis. MHI has been active for many years in seeking solutions to product liability and safety problems, and has established a special steering committee, on which I serve as chairman, to concentrate on those problems. MHI has engaged in an extensive educational program to make the public aware of the product liability crisis.

MHI has employed the services of Shea Management Inc., a multi-association management company located in Pittsburgh, to assist the steering committee in its work. Finally, in my capacity as chairman of the steering committee I have served as a consultant and have testified before many state legislatures during their deliberations concerning product liability legislation.

B. MHI's commitment to safe products

As the members of this committee know, product liability means the legal responsibility of a manufacturer or seller of a product to compensate a consumer who has been harmed by the product. This concept is not new, and MHI's interest in product liability reform is not an attempt to escape our responsibility to manufacture equipment that can be used safely. We are committed to providing equipment that is designed and produced according to the most current modern safety developments, equipment worthy of its intended purposes. We are committed through labeling, operating instructions, advertising and disclosure to insure that our customers know the proper and safe methods of operating our equipment. As an example of our commitment to safe equipment, and product liability reform, I ask the Committee to include as part of its records of this hearing a booklet recently published by MHI which stresses the need for the development and implementation of loss prevention programs by manufacturers. I also request that two other booklets published by MHI on product liability be included as part of the record of this hearing.

C. New theory of product liability

MHI recognizes, however, that loss prevention programs by manufacturers will not solve the product liability crisis. What has created the crisis is a deluge in product liability litigation in the last few years fostered by a new standard of product liability which results in strict liability for the manufacturer. The Illinois Supreme Court put the matter in clear perspective, stating, "In recent years the law governing the liability of a manufacturer to a purchaser of goods with whom he has not dealt personally has undergone great change. This change has involved a revolution in terms of legal theories employed to describe the liability of the manufacturer to the purchaser".

The revolution of legal theories referred to by the court has left in its wake a strict liability-oriented system of resolving product claims that creates problems greater than those it was supposed to solve. The product liability system no longer fairly adjudicates claims based upon fault, but instead has become a convenient way to pay whenever someone is injured. It is the rapid change in the law, not an increase in the number of accidental injuries, that has made product liability a major crisis for both businesses and consumers. This was confirmed by a May 1977 Commerce Department report stating that there is no evidence that increases in product liability claims and lawsuits are due to increases in the number of accidents.

II. EVIDENCE OF THE CRISIS

Considering the multitude of studies, reports and congressional hearings on the subject it would seem unnecessary to prove, or even to discuss at length, the existence of a product liability crisis. Recent assertions, however, that there is no product liability crisis justifies a brief review of the background and evidence of a product liability problem. In the early 1970's businesses across the country found that their premiums for product liability insurance coverage were increasing substantially. By the mid-seventies, a significant number of businesses were experiencing increases of several hundred percent and many others were unable to obtain liability coverage at any price. In response to this worsening situation, a Federal Inter-Agency Task Force, headed by the Under Secretary of Commerce, was created in 1976 to conduct a study of the product liability problem. In November of last year the Task Force issued its final report. Confirming the experience of the business community, the report found that product liability premiums have increased substantially for manufacturers of many products, including manufacturers of equipment. Specifically, the report found that:

Increases in product liability premuims from 1975–1976 averaged over 200 percent. For some industrial firms, the increases were over 1,000 percent. (Incidentally, some of our members have experienced a 2500% increase in premiums in two years even though they have not filed a single claim.) ;

Increased product liability costs may be one of the several factors causing small manufacturers to terminate operations; and

The impact of premium increases has been greater for small as compared to larger businesses.

The report found that "Product liability presents a potential disruptive effect on the economy" and that "the instability in product liability has increased costs, apart from verdicts and settlements. It has created a climate where it may be rational for a plaintiff's lawyer to bring a case, although existing rules suggest that it cannot be won".

Let us look at some of the other evidence of this crisis. The April hearings of the Subcommittee on Capital, Investment, and Business Opportunities of the Committee on Small Business of the House of Representatives, contained a study on the effect on premium increases on small business. This study, based on a survey of 32,000 small manufacturers, revealed that one in twelve small manufacturing firms cannot afford product liability insurance and another one in six cannot afford desired limits. Other findings were:

Product liability insurance rates are escalating at a rapid rate;

One in eight firms is failing to develop a new product and one in twenty is dropping a product due to liability considerations; and

One in four companies surveyed have had to reflect the increased cost of premiums in a substantial increase in the cost of their product. (As an example of the inflationary impact of product liability premiums we have found that the high cost of insurance has in some cases resulted in a 10% increase in the cost of a lift truck.)

Similarly, in a recent survey of metal working companies, it was revealed that their product liability lawsuits for a five year period had increased by 118% over a prior five year period. The average cost of these lawsuits had increased by 333%. There are many figures like these which reflect the increasing cost of product liability for a particular industry or part of the economy, but unfortunately there is no reliable total figure as to the cost of product liability to the economy as a whole.

D. Cost to the economy

I attempted to obtain some idea of the cost to the economy as a whole by using the Cook County figures of jury awards and the closed claims survey of the insurance industry quoted by the Task Force report. I came up with some reasonable dollar figures. First, the average award of 872 cases in 1976 in Cook County, Ilinois was $176,000. Cook County is a highly industralized area but is not the area of the highest average court award. This doubtful honor is reserved for the state of California. During the same period, California had an average award of approximately $190,000, if my memory serves me correctly.

Secondly, the Task Force's report estimates that 70,000 product liability lawsuits is a reasonable assumption for a national total in the 1976–1977 court year. I have reason to believe this figure to be much too low. However, by multiplying the 70,000 figure by $176,000 we arrive at a total cost of $12.3 billion. If I am only half correct, we are talking about a $6.15 billion cost to the nation. Either figure is alarming and clearly reveals a significant adverse effect on the national economy.

III. LONG-TERM SOLUTION

MHI's Legislative Program

The solution to the product liability crisis will not be simple and will not be achieved easily. It will require the enactment of basic reforms by the states. MHI has established a 9 point legislative priority program in its drive for product liability reform. These reforms include the adoption of a 6 year statute of limitation from the date the product is sold, leased or delivered to the first user, and the establishment of defenses to the doctrine of strict liability. Other parts of our legislative program involved the collateral source rule, punitive damages, the duty to warn, workmen's compensation, contingency fees and a product liability review panel. I understand that these proposals are beyond the scope of today's hearing, but I wish to inform the members of the Committee that MHI has been working on the product liability problem for many years and has developed what we believe to be a fair and reasonable solution to the problem. MHI would welcome the opportunity to discuss at some other time these proposals with any member of this Committee.

IV. SHORT-TERM RELIEF

A. S. 3049

MHI believes that an amendment to the tax law could provide immediate relief to business in coping with the product liability crisis. MHI strongly urges the members of this Commitee to amend the Internal Revenue Code along the lines of S. 3049, introduced by Senators Culver and Nelson, to permit businesses to set aside a portion of their pre-tax income to fund a specific reserve for self-insurance against product liability claims and related costs. S. 3049 would:

Provide immediate relief to both small and large businesses affected by the product liability problem;

Help small businesses by allowing them to utilize higher deductibles and thus lower the cost of their product liability insurance;

Encourage the use of product liability loss prevention because the manufacturer would have a direct incentive to reduce loss resulting from product liability claims;

Reduce the cost of product liability insurance by creating competition and allowing businessmen to self insure potential liabilities up to certain limits; and

Provide needed flexibility for cyclical industries, such as the material handling industry, which would be able to set aside reserves during more profitable years.

Even if there were no product liability crisis, enactment of S. 3049 would be justified and needed. While there is no business deduction available for funds set aside into a reserve for product liability, the cost of premiums for commercial insurance is fully deductible. This tax system provides an artificial distinction encouraging one form of product liability protection—commercial insurance—over another form—self insurance. This tax system places businesses at a distinct disadvantage in dealing with the insurance companies, who are able to charge practically whatever they wish for product liability coverage.

Many large corporations have dealt with this situation by establishing captive insurance companies. Most of these captives operate offshore. There are now over 700 insurance companies in Bermuda. In this way big corporations can take business deductions for the cost of the insurance premiums, a technique obviously not available to the small businesses. While the use of a captive insurance company is both understandable and legal, the tax code should not encourage large companies to drain capital from the country; nor should it create an artificial distinction and economic advantage to one form of product liability protection over another form.

B. Precedent for S. 3049

The Committee established a precedent for S. 3049 when, under the leadership of Chairman Long and Senator Hansen, it permitted tax deductible self-insurance reserves for Black Lung benefits. S. 3049 will have safeguards and limitations similar to those of the Black Lung legislation. Like the Black Lung Act, S. 3049 severely limits the use of the funded reserves. If product liability reserves are used for anything other than product liability matters, S. 3049 enacts harsh tax consequences for these misdirected funds.

C. Administration Proposal

On July 20, 1978 the Administration announced its program to solve the "serious economic problems caused by escalating product liability premiums". MHI applauded this first recognition by any administration of the existence of a serious product liability problem.

As part of its program, the Administration proposes to amend the Internal Revenue Code to permit manufacturers to carry back product liability losses for a period of ten years as opposed to the three year loss carryback provision in current tax law. The ten year carryback proposal would be of help only to the relatively few taxpayers who experience catastrophic product liability losses which exceed their total profits over a three year period. Consequently the carryback proposal would do little to ameliorate the present plight of most manufacturers and would not give them the protection of an existing fund to be used for smaller but more numerous product liability settlements and defense costs. Moreover, many of our member's customers require the vendor to have product liability coverage or some type of self-insurance before the completion of a proposed sale. A funded reserve may meet this requirement. The carryback proposal clearly does not.

Accordingly, MHI urges this Committee to enact as a separate bill or as an amendment to a H.R. 13511, "Revenue Act of 1948", a product liability self-insurance bill similar to that contained in S. 3049, coupled with the Administration's proposal by including a six year carry-forward to help those companies that have profits in future years and expanding S. 3049 to provide reasonable limits.

A six year carry-forward would be particularly helpful to a new and struggling business in handling the immediate need for product liability protection. This carry-forward would provide a tax credit to be used immediately in any profitable years to offset the previous cost of product liability. The taxpayer would have the flexibility to choose which of these tax methods is best suited to meet his needs. Such a product liability tax relief package will provide adequate protection from product liability insurance problems. We are confident that this Committee can fashion such a comprehensive product liability tax relief program.

V. Conclusion

The material Handling Institute appreciates this opportunity to express our views on tax legislation which could be of great assistance to businessmen in handling the product liability crisis.

Senator BYRD. I think at this point it would be well to get the viewpoint of the Treasury Department. Mr. Daniel Halperin is present. He is a tax legislative counsel for Treasury. Mr. Halperin, would you care to comment on this legislation?

STATEMENT OF DANIEL HALPERIN, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. HALPERIN. Thank you, Mr. Chairman.

One thing is clear here. The tax changes being asked for today will add an additional amount of complexity to the Internal Revenue Code. There would have to be some kind of limit on what could be set aside in a reserve, and we have heard from different people here today suggesting different limits. There does not seem to be agreement as to what the limit should be. There also would have to be rules which would prevent the use of the reserve for purposes other than paying product liability claims, and there would have to be some kind of recapture penalty, in case the reserve is used for a different purpose, to avoid any advantage from setting aside the reserves.

There is no real way to control the size of the reserves. The bills are either based on flat amounts or percentage of sales. These reserves would in no way be related to the actual loss experienced of particular companies, which would create the problem of excessive reserves being set up.

Clearly, on one side we have this complexity that we are getting into if we go this route. On the other side of this is the question of whether the tax law change being asked for here is really going to solve the problem, and I do not think it can.

On the revenue estimate side, we do not agree with the large numbers that were mentioned. Our estimates are about $135 million in the first year—declining to about $85 million by the fifth year—that a proposal like this would be in effect, and the reason for that would be that there is not a tax disadvantage under present law. Now, that is rather difficult to explain without a blackboard and a lot of numbers, but I think very simply the advantage supposedly available with insurance is that, if you pay an insurance premium, you can deduct it. If you put $100 into an insurance cnract, you can deduct that now. If you are self-insuring,

you cannot deduct it until you have a loss, but if that insurance company invests the money and makes a profit on its investment, the amount it will have available to pay losses will exceed the $100 collected in premiums, say it will be $150 by the time the loss occurs.

The company that is self-insured will, at the time it incurs that $150 loss, gets a $150 deduction, so that there is a delay in the deduction for those who self-insure until the time the loss occurs. The amount of the deduction is larger because it will be the amount actually paid for the loss, while the premium paid should be smaller, because there will have been some income earned on the reserves set aside, and those two are precisely equivalent. The delay in deduction is compensated for by the amount by which the deduction is increased, and therefore there is no tax disadvantage to self-insurance as opposed to buying commercial insurance.

The tax advantage that would come about from this bill would either be because the trust would be tax exempt or because at the time the payment is made out of the self-insured trust, it appears that one of these bills would allow an additional deduction for the difference between the amount contributed and the actual amount of the loss.

Now, we do recognize that there can be a tax disadvantage for self-insurance if losses are irregular. People who pay premiums regularly can deduct them against the income of the current year. If a loss should come up, a large loss would come up once in 10 years, there may not be enough profits in that 10th year against which to offset the loss and the carryover period may be inadequate, and that is the purpose of the administration proposal, which would allow a 10-year carryback for product liability loss.

With that, there ought not be any disincentive to setting up a reserve. People are obviously free to set up a reserve in any event, whether or not they get a tax deduction. A company can put aside an amount of money to protect itself against product liability losses. Of course, if it cannot get a tax deduction, it likely in the 50-percent bracket to put away only half as much, so if it would put away $100 before taxes, it might put away only $50 after taxes.

But that difference is misleading, because at the time the loss occurs, if there has been no current deduction for the set-aside—that is, if present law applies—it will get a tax deduction for that loss, and it will be able to get from the Government approximately, at a 50-percent bracket, the same amount of money that is in the reserve. So, if there is a reserve of $1,000, it will be adequate to pay for a loss of $2,000, because a deduction on account of the loss of $2,000 will produce a $1,000 tax refund.

The 10-year carryback provision will insure the refund will be there. So, we think with the 10-year carryback there is no disincentive. The tax treatment is the same between those who self-insure and those who buy commercial insurance. The additional complexity that would come into the law from the proposals that have been described here today will not be there, and therefore we think that there is no need for any change now, other than the one which has been supported by the administration.

Senator BYRD. In brief, Treasury opposes the enactment of the proposed Senate legislation?

Mr. HALPERIN. That is correct, sir.
Senator BYRD. Senator Packwood?
Senator PACKWOOD. No questions, Mr. Chairman.
Senator BYRD. Thank you, gentlemen.
Mr. STEWART. Mr. Chairman, before the record is closed, I think there ought to at least be a recognition of two points. May I take just a second?
Senator BYRD. Go ahead.
Mr. STEWART. No. 1, you see an obvious difference of opinion between the representative of the insurance industry and the representative of insurance brokers. Second, the argument of simplification that has been made by the Treasury versus complexity, as I anticipated when I made my brief remarks, is always present when the Treasury is opposed to something on other grounds. There is not unacceptable complexity involved in the proposals before this committee, or in our proposal, or in proposals of other industry witnesses.
Thank you, sir.
Mr. HALPERIN. Mr. Chairman, may I just respond to that? It seems to me that there obviously is complexity in the proposal. The question is whether it is worth it. Are you getting enough of an advantage out of it to be worth the complexity you are buying? I do not think there has been any demonstration that you are. I think the main reason we are opposed to this is the complexity. You can get the revenue loss out of it by making it even more complex than it is now. It can be made revenue neutral, and presumably that is all they should be asking for.
They are asking for equal treatment with commercial insurance, and you can get that by a very complex rule, a little bit more complex even than these statutes, but the question is, why are we doing it? And I do not see the argument has been made why we would do it.
[The prepared statement of Mr. Halperin follows:]

STATEMENT OF DANIEL I. HALPERIN, ACTING DEPUTY ASSISTANT SECRETARY (TAX LEGISLATION), OFFICE OF TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of this Subcommittee: I am pleased to have this opportunity to appear before you this morning to present the views of the Department of the Treasury on the nine bills on the Subcommittee's agenda. These bills range from items that the Treasury regards as relatively noncontroversial to those that raise what we view as very serious policy problems meriting considered review by this Subcommittee. With respect to the less controversial or more narrow items—H.R. 810, H.R. 4030, S. 2771, H.R. 5099 and S. 3345—I will outline briefly the Treasury's position, elaborating in appropriate instances in the appendix to my testimony.

The bulk of my testimony will be devoted to S. 1611 and S. 3049, both of which deal with product liability; S. 3176, dealing with contributions in aid of construction to the capital of certain public utilities; and S. 3341, the "Independent Local Newspaper Act of 1978".

H.R. 810, H.R. 4030, S. 2771, H.R. 5099, S. 3345

H.R. 810 we regard as relatively noncontroversial. The Tax Reform Act of 1969 added a provision to the Code (section 4941) which in general prohibits certain transactions between private fundations and certain "disqualified persons," by imposing a graduated series of excise taxes on the disqualified person (and in certain circumstances on the foundation manager). Government officials are "disqualified persons" for this purpose except for certain specifically set forth transactions including the payment of expenses of domestic travel. The bill would

provide an additional exception for payment or reimbursement of foreign travel expenses of a government official by certain foundations within specified limits.

The Treasury Department recommends that H.R. 810 be amended to limit the permitted amount of reimbursable transportation expenses to the cost of the lowest coach or economy air fare charged by a commercial airline.

The recommended change would make the reimbursable amounts under the bill consistent with the limitation on deductions for attending foreign conventions under the Administration's 1978 tax program. Treasury would not oppose H.R. 810 if this change were made.

H.R. 4030, in contrast would amend the provisions governing the activities of private foundations in a manner the Treasury does not support. It would create an *ad hoc* exception to the tax on excess business holdings of a private foundation (section 4943) in cases where the foundation owns over 50 percent of the voting stock of a public utility which had taxable income of less than $1 million during its first taxable year ending after May 26, 1969 if certain other conditions are met. While there were a variety of considerations underlying the provisions of the Tax Reform Act of 1969 that were designed to eliminate the use of private foundations to preserve control of business enterprises, one principal consideration was that the presence of control on the part of the foundation would tend to direct the foundation's efforts toward operating the business and to divert its attention from its legitimately charitable purposes. The Treasury Department opposes H.R. 4030 not only because it creates a special *ad hoc* exception to section 4943, but also because, by preserving the opportunity for private foundations to control certain kinds of taxable businesses, it would tend to undermine one of the policies of section 4943. Our views on H.R. 4030 are set forth in greater detail in the appendix.

S. 2771 would exempt from the unrelated trade or business income tax generally applicable to exempt organizations, income from the conduct of bingo and similar games of chance. Eligible games are defined as those in which wagers are placed, winners determined, and prizes distributed in the presence of participant. The bill also would require that such games not be "ordinarily carried on on a commercial basis" and that their conduct not be in violation of applicable local law. One of the underlying policies of the unrelated business income tax is to prevent unfair competition by tax exempt organizations with commercial enterprises. Because in many states bingo may be regularly carried on only by exempt organizations, it is arguably consistent with this underlying policy not to tax the income from such games. Consequently, Treasury would not oppose this legislation provided that it was limited to the conduct of bingo and did not confer tax exemption on income from other, essentially casino activities; and, that it was limited to the conduct of bingo in jurisdictions where, under applicable law, bingo may lawfully be carried on only by exempt organizations. We also regard it as essential to clarify S. 2771 to provide that exempting the income from bingo does not foreclose the possibility, which exists under current law, that where bingo has become an overly substantial part of the organization's activities the organization may forfeit its tax exemption. Modified in this fashion, the Treasury would not oppose this legislation. We do not endorse the effective date, which is retroactive to 1969.

The Treasury is also unable to support *H.R. 5099*, which would provide relief for two individuals who were unable to sell their old principal residence within 18 months after purchasing a new principal residence and thus did not qualify for the rollover of section 1034. It adversely affects the equity of our tax system to create special exceptions for particular taxpayers to general limitations with which the rest of us must comply. This bill would provide just such special relief. It has been suggested in support of this legislation that these individuals could have qualified for an extension of the rollover period available under section 1033 if their property had been involuntarily converted. We have concluded, for the reasons set forth in greater detail in the appendix, that this premise is incorrect. The Treasury opposes H.R. 5099.

Finally, the Treasury supports *S. 3345*, which would make available to certain regulated investment companies—those that constitute Small Business Investment Companies (SBICs)—a deficiency dividend procedure similar to that now available for personal holding companies and real estate investment trusts. The Treasury sees no reason, indeed, why a deficiency dividend procedure should not be made available to all regulated investment companies, provided that the procedure were made identical with that accorded real estate investment trusts by the Tax Reform Act of 1976. (*See* §§ 1601(b)-(f) of P.L. 94-455.)

PRODUCT LIABILITY (S. 1611, S. 3049)

Mr. Chairman, I would now like to turn to *S. 1611* and *S. 3049*, both of which are measures designed to facilitate self-insurance of product liability risks. With the Chair's consent, I would also like to consider with the Subcommittee an Administration-sponsored alternative to the approach taken by S. 1611 and S. 3049, both of which the Administration opposes.

Both S. 3049 and S. 1611 would amend Section 165 of the Code to provide current deductions for contributions to product liability self-insurance accounts. In both instances, annual contributions would be limited to a percentage of gross revenues subject to a dollar maximum, and the aggregate funding of the trust would similarly be subject to both percentage and dollar limitations. S. 3049, which constitutes the more comprehensive treatment, provides separate limitations for taxpayers in general and for those having a "severe product liability problem." Contributions are required to be made to an independently trusteed, segregated account, the assets of which may be invested only in Federal, State or local debt securities or instruments of deposit in a financial institution, and which may not be used for any purpose other than satisfying product liability losses. To the extent a product liability loss is paid out of the proceeds of the account, no further deduction under Section 165 is allowed, and penalty taxes are imposed to insure that proceeds of the account are not used for an inappropriate purpose. Special rules are provided for groups of affiliated companies and for contributions to a wholly-owned (or "captive") insurance company.

The tax treatment of product liability self-insurance is a subject that not only has been the source of lively public and Congressional debate, but has received a most thoroughgoing review by the Administration. My testimony on this subject will constitute an effort to share with this Subcommittee the reasons that have led the Administration to oppose S. 1611 and S. 3049 and to endorse an alternative proposal that would extend to ten years the carryback period for net operating losses attributable to product liability.

The nature and degree of the product liability problem has been thoroughly studied by an Interagency Task Force headed by the Department of Commerce. In its Final Report, the Task Force outlined a number of steps, including a variety of tort law revisions and changes to casualty insurance ratemaking practices, that ought to be seriously studied and possibly implemented to deal with the root causes of the product liability problem. At the same time, the Task Force Report suggested that interim relief might be provided through the tax system. The relief considered in the report would have been to permit deductions within certain limits for contributions to self-insurance trusts. This proposal was recognized by the Task Force as being of an admittedly short-term nature, and to constitute no substitute for longer term revisions to local tort law and insurance ratemaking practices needed to deal with the root causes of the product liability problem. Moreover, the short-term tax recommendation was based principally on the perception that by permitting deductions for casualty insurance premiums but not for contributions to self-insurance funds, the tax law discriminated against self-insurance. The Task Force Report cautioned, however, that any such proposal should not be advanced without a more thorough study of its merits.

That follow-up study has now been completed. The Administration's conclusions and proposal were announced by Commerce Secretary Kreps on July 20, 1978. The reasons that led the Administration not to endorse a deduction for contributions to product liability self-insurance reserves are essentially three. First, the superficially appealing notion that the tax law discriminates in favor of commercial insurance and against self-insurance is in fact based on a misapprehension. Second, the existing proposals for current deductibility of contributions to self-insurance trusts provide an opportunity for deferral of taxes and thereby would operate to subsidize self-insurance. Because self-insurance is inherently inefficient by contrast with commercial insurance, and because of technical difficulties stemming from the inability to estimate future product liability losses, we concluded that extending such a subsidy would not be appropriate. Finally, we concluded that existing law, with some modification, would provide virtually the same tax benefits, other than deferral, as proposals providing current deductibility for contributions to a self-insurance trust, and with far less administrative complexity. The necessary modification, as I have already noted, would be to amend current law to provide a special 10-year net operating loss carryback, in contrast to the three-year net operating loss carryback generally available under current law,

for losses attributable to product liability. Let me now explore each of these reasons in somewhat greater detail.

It is a misconception to believe that, because commercial insurance premiums paid in the ordinary course of a trade or business are deductible and contributions to a self-insurance trust are not, the tax law discriminates against self-insurance. Product liability losses incurred in a trade or business are, of course, deductible when insurred under section 165 of the Code. The deduction under 165 is disallowed, however, for any loss to the extent such loss is "compensated for by insurance or otherwise." Thus, the enterprise paying premiums for commercial product liability insurance may only deduct those premiums when paid or incurred. To the extent the loss is reimbursed by the insurer, however, *no further deduction is permitted*. Consequently, the tax treatment of self-insured and commercially insured losses is essentially symmetrical. There is no discrimination to be cured.

In view of the fact that the tax law does not discriminate against self-insurance, some other rationale for permitting current deductions to self-insurance trusts must be found. And, in considering the possibilities, one must recognize that conferring current deductions for contributions to self-insurance trusts, where such trusts are tax exempt, invariably gives rise to tax deferral.[1] That deferral constitutes a subsidy to self-insurance. Consequently, the pivotal question is whether any subsidy, and if so whether a subsidy in the form of deferral, is warranted.

Taking the second question first, the Administration concluded that if a subsidy for product liability self-insurance was appropriate, deferral was not the appropriate mechanism by which to deliver it. The benefits of deferral vary with the marginal rate of the taxpayer and with the period of time for which taxes are deferred. Thus, while a good many corporate taxpayers are in the top 48 percent bracket, those in lower brackets would benefit less. Similarly, the greatest benefits would accrue to those whose funds remained on deposit the longest, who well might be those with less in the way of product liability losses. Finally, because a subsidy in the form of deferral is off-budget, it is subject to less rigorous scrutiny than a subsidy required to be appropriated.

The Administration also concluded that the case for subsidizing self-insurance of product liability losses generally was not strong. The principal basis for this conclusion was that self-insurance very well may be the least efficient form of insurance. By "least efficient", I mean simply that, to self-insure, the insured party is required to put up to $1 of capital for every dollar of risk insured. Because, in contrast, commercial insurance involves the pooling of covered risks, the amount of capital required per dollar of coverage is significantly smaller. Consider, for example, the case of four business enterprises each of which is reasonably certain that it will incur a $100 loss at some time during the next four years. None is certain when its loss will occur but probability tells us that if each of the participants has a one-in-four chance of incurring a loss during each of the next four years, it is likely that one of the four will incur a loss each year. For each firm to self-insure would require each to place roughly $100 in a self-insurance trust. If the four were, instead, to engage in a pooling arrangement similar to mutual insurance, each would have to tie up only roughly $25 each year. The $100 ($25 from each participant) would be pooled in the participants' mutual insurance company and would be used to pay the likely claim of the one participant who incurred a loss each year. By sharing their risks, each participant would thus be able to spread its contribution to the shared risks over a four-year period, rather than having to self-insure for nearly the full $100 for the entire period. Because of such economies in a risk-sharing arrangement, commercial insurance is inherently more efficient than self-insurance.

The problems with self-insurance are compounded where, as in the case of product liability, it is next to impossible to predict the magnitude of future risks. This difficulty is reflected by the fact that both S. 1611 and S. 3049 provide for deductions limited, not by a taxpayer's anticipated experience, but by a percentage of sales subject to ceilings on annual contributions and maximum funding of the product liability loss reserve account. Because such contributions are not limited, and indeed in practice could not be limited, to amounts that bear some relationship to a taxpayer's actual experience, the contibutions to such accounts well might be excessive for some taxpayers, wholly inadequate for others,

[1] The earnings of the trust are in effect taxed at the time of the loss since no further deduction is allowed even though the loss exceeds the original contribution.

and in only random instances would bear any relationship to the need of particular taxpayers. Because of this randomness, the amount of subsidy afforded by these proposals would also be random.[3]

Finally, the existence of exempt, self-insurance trusts would require complex administrative controls. For one thing, the Internal Revenue Service would be required to insure that such trusts were not overfunded and that their investments were limited in the manner required by, for example, S. 3049. Moreover, extremely complex accounting would be required to define the appropriate tax treatment to be applied on nonqualifying distributions from, or liquidations of, such product liability loss reserve accounts. Presumably, the sponsors of such provisions would wish to provide that, if an enterprise established a product liability loss reserve account and, after a number of years, decided that it no longer needed the account, the taxpayer should reap no benefits by virtue of having established and maintained the account. In order to give effect to this result, extremely complex accounting provisions would be required to bring the taxpayer back to square one. It would, I should note, not be sufficient simply to provide that all amounts distributed from the account be subjected to tax.

For all these reasons—the fact that self-insurance is inherently inefficient, the fact that contributions to such accounts would bear no relationship to a taxpayer's actual experience, and the administrative complexity that these proposals would entail—we do not think the Congress should endorse a provision that would subsidize such self-insurance through the tax system.

Having concluded that the Administration should not endorse proposals to subsidize through the tax system self-insurance of product liability risks, did not stop there. Apart from its deferral aspect, a proposal to allow a current deduction for contributions to a self-insurance trust can be regarded as a method of averaging product liability losses over a period of several years. For example, a taxpayer who put a thousand dollars in a product liability loss reserve account for each of 10 years, and who at the end of that 10 years incurred a $10,000 product liability loss, would effectively have spread the burden of that loss over a 10-year period. Thus, we asked whether there were and revisions to current law that might accomplish this result but that would not entail deferral. Under current law, the method by which taxpayers are permitted to average losses over a longer period than the year in which the loss is incurred is in the net operating loss carryover provisions of Section 172 of the Code. In general, a net operating loss may be carried back and applied against taxable income earned during the three years preceding, and carried forward and applied against income in the seven years following, the year in which the loss was incurred. Where a net operating loss is carried back to a prior taxable year, it is applied against income earned during that year and gives rise to an immediate claim for refund of taxes paid on that income. In view of the fact that product liability may give rise to sporadic but extraordinary losses, we were prompted to inquire whether the three year carryback period of current law was adequate. In this connection, we noted that in some instances, for example financial institutions, the Congress had

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[3] Indeed, the amounts for which S. 3049 and S. 1611 would permit tax deductibility would not be properly accruable for financial accounting purposes. A reserve for self-insurance of possible future losses is in the nature of a general contingency reserve, the contingency in the case of S. 3049 and S. 1611 being possible future product liability loss. Statement number 5 of the Financial Accounting Standards Board ("FASB") provides that before liability for a loss contingency may be recognized, (1) information available must indicate that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statement, and (2) the amount of the loss must be reasonably estimated. Under these provisions, contingency reserves constitute liabilities for which no accrual is permitted and FASB Statement number 5 specifically so provides. A potential liability of this type need not bbe disclosed in supplemental information unless there is a reasonable possibility that a loss has been incurred. This treatment is required by generally accepted accounting principles even though the reserve is funded through a segregated trust or through the use of a captive insurer.

It is also worth noting that amounts for which a deduction would be permitted by S. 3049 or S. 1611 would not have been deductible under the general rules, once promulgated by Congress, that would have conformed tax accounting to general accepted accounting principles. As originally enacted, the Inernal Revenue Code of 1954 contaned two sections—Sections 452 and 462—which would have allowed for theh deferral of prepaid income and deductibility of additions to reserves for estimated expenses. These provisions were repealed retroactively in 1954. It is noteworthy that the regulations promulgated under Section 462 provided that allowable reserves for estimated expenses did not include reserves for general, undetermined contingencies for indefinite possible future losses. *See* Regulations Section 1.462-5(b)(4), T.D. 6134. Thus, even under the liberal standards of former Section 462, no deduction would have been allowed for additions to reserves for product liability losses.

already concluded that a net operating loss caryback period of longer than three years would be appropriate, and we asked whether a similar proposal might not be adopted for net operating losses attributable to product liability. We have concluded, Mr. Chairman, that it would. Consequently, as you know, on August 1, 1978, the Administration forwarded to Chairman Long, Chairman Ullman and other interested members of the Congress a proposal to modify Section 172 to provide a ten-year net operating loss carryback for losses attributable to product liability.

Mr. Chairman, we believe that this net operating loss carryback proposal constitutes an appropriate tax response to the product liability problem and should be endorsed by this Subcommittee in lieu of proposals such as S. 3049 and S. 1611. As modified by this proposal, we believe that current law will provide nearly all the benefits to taxpayers—other than deferral of taxes—that they would obtain from being permitted to deduct contributions to a product liability self-insurance trust. In this connection, I would like to consider two arguments that have been raised in support of the contention that allowing a deduction for product liability set-asides would be preferable to current law, even as modified by the ten-year net operating loss carryback that the Administration has proposed.

First, it is said that by encouraging businesses to establish self-insurance reserves for product liability, measures such as S. 3049 would facilitate retention of product liability risks and put pressure on the insurance industry to reduce rates for commercial product liability coverage. The answer, we believe, is that nothing in current law precludes a firm self-insuring by setting aside some reserves—in tax paid rather than pre-tax dollars—to provide for product liability risks. Indeed, a firm that desired to obtain under current law the equivalent in self-insurance through contributions to a self-insurance trust would be required to put up roughly half the amount in tax paid dollars as would be required for a reserve funded with pre-tax dollars. This difference arises because, when a reserve is funded with after-tax dollars, the loss against which the reserve is maintained remains fully deductible and the deduction gives rise to a corresponding decrease in Federal income tax liability. Businesses will, therefore, remain free to self-insure a portion of their risk with after-tax dollars, knowing that, through their ability to deduct the loss, they are essentially "insured with the government" for the amount of the tax benefit of the deduction. Moreover, if the ten-year net operating loss carryback proposal is adopted, as we believe it should be, such businesses will have the assurance that the government will defray a portion of their loss even if they have no taxable income in the year the loss is incurred.

Second, it has been suggested that when a firm establishes a self-insurance reserve, the knowledge that its own money is "at stake" should a product liability loss be incurred will encourage it to show greater concern for the safety of its products. We believe that, under current law, and as modified by the Administration proposal, the incentive to make safe products will be every bit as great. The firm that self-insures without providing segregated self-insurance reserves—the firm that "goes bare"—has perhaps the greatest incentive to make safe products since, absent commercial coverage or a reserve, the equity in its business is at stake. This incentive would not be reduced by extending the net operating loss carryback for product liability losses. While the availability of that carryback would tend to insure that each taxpayer will realize immediately the tax benefits of being able to deduct the loss, even for a taxpayer in the 48 percent tax bracket, the government only pays 48 cents on each dollar of loss. To the extent of the other 52 percent, the taxpayer's reserve (if it has one), or its equity in its business (if it does not), remains at risk for the loss. Consequently, we do not think current law as modified by the ten-year net operating loss carryback, will diminish at all the incentives that exist to produce safe products.

In sum, Mr. Chairman, we believe that current law, as modified by a ten-year net operating loss carryback, provides an appropriate response to those who desire to encourage self-insurance of product liability risks. We think it would be far more equitable than either S. 3049 or S. 1611, since it would not involve tax deferral. We think it is far more efficient, since it neither requires nor forecloses businesses from setting up self-insurance reserves—with tax-paid dollars—at the level they consider to be appropriate. And we think it would be far more simple to administer, since the loss carryback would come into play only to the extent it was necessary, and would not require cumbersome administrative machinery to police the use of self-insurance trusts. For these reasons, the Ad-

ministration urges the Subcommittee to give favorable consideration to the ten-year net operating loss carryback proposal. It would oppose adoption of either S. 3049 or S. 1611.

CONTRIBUTIONS IN AID OF CONSTRUCTION TO THE CAPITAL OF PUBLIC UTILITIES (S. 3176)

S. 3176 would make contributions in aid of construction to regulated electric energy or gas public utilities eligible for treatment as nontaxable contributions to capital under section 118(b). This bill, which is framed as an extension of the treatment currently accorded water or sewerage disposal facilities by section 118 (b) of the Code, invites this Subcommittee to reexamine the rationale for current law.

Section 118(b), added by the Tax Reform Act of 1976, provides that amounts received after January 31, 1976, as contributions in aid of construction by a water or sewerage disposal utility which are used for qualified expenditures and which are not included in the utility rate base for ratemaking purposes are treated as nontaxable contributions to capital of the utility.

An amendment to extend section 118(b) treatment to electric and gas utilities was offered on the Senate floor and defeated. The relief was limited to water and sewerage utilities because it was felt that they were more significantly affected than were other utilities. Moreover, the revenue loss, measured from a base which treated contributions as taxable income, was manageable if confined to water and sewerage facilities but could be as high as $200 million if gas and electric utilities were included.

The issue posed by S. 3176 is the appropriate tax treatment of contributions in aid of construction in general. The further question of what taxpayers other than water and sewerage disposal utilities should receive section 118(b) treatment must be dealt with as a separate issue only if it is decided that section 118 (b) is correct as a general matter.

This is an extremely difficult and complex issue which is currently under study by the Treasury Department. Put simply, Treasury believes that section 118(b) is incorrect and can permit substantial amounts of income to be received tax free.[3] However, we would also agree that in some circumstances full current taxation of so-called "contributions to capital" would overstate actual economic income. Thus, in the absence of section 118(b) utilities would have to seek other forms of financing.

The issue posed is whether it would create significant difficulties for utilities and their customers, beyond a loss of tax exemption for real income, if they had to use the other means of financing. If this can be shown then we must either decide to provide a tax benefit or seek a third solution (which will not be easy) which will correctly measure income. In any event, we believe the matter requires substantial study and we continue to welcome input from all interested parties.

THE "INDEPENDENT LOCAL NEWSPAPER ACT OF 1978" (3341)

S. 3341, the "Independent Local Newspaper Act of 1978," is designed to provide tax relief to those who own independent "local" newspapers. The Treasury Department opposes this bill, which in reality constitutes special relief legislation.

The bill is divided into two principal parts. The first permits the establishment of a trust by an independent "local" newspaper for the purpose of paying the estate tax attributable to any owner's interest in the business. The trust must have an independent trustee and is corpus may be invested only in United States obligations. The value of the trust cannot exceed 70 percent of the value of the owner's interest in the business. The income earned on the trusteed assets will be exempt from tax. The transfer of assets to the trust is deductible by the newspaper business, but is also excluded from the taxable income of the owner. The corpus of the trust is excluded from the owner's gross estate and the estate does not realize income when its estate tax liability is discharged by the trust.

The newspaper must have all its publishing offices located in a single state, and if it is a partnership or corporation, it cannot be traded on an established

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[3] Contributions in aid of construction represent a present payment for future services. As such they constitute gross income to the recipient. If we were to stretch the facts and assume that the contributor has made a loan to the utility to be repaid through reduced charges for services, it would seem that "interest" on this hypothetical loan should be taxed.

securities market. Deductions for transfers from the business to the trust are limited to 50 percent of the business profits.

The second part of the bill provides for an elective deferral of the estate tax attributable to the newspaper interest not otherwise paid from the assets of the estate tax payment trust essentially on the same terms as Code section 6166, with the same preferential 4 percent interest rate but without regard to the size of he interes in relation to the owner's esate.

I would like to take a few moments to examine the major aspects of the bill. First, the bill permits a deduction for earnings diverted to the estate tax payment trust. Although the bill provides that such a deduction is allowable under section 162, the payment in no way can be said to meet the "ordinary and necessary" business expense criteria of that section. Nor, is there in the tax law any other provision similarly allowing a deduction for amounts to be used to pay death taxes.

Second, the bill provides that the funds transferred to the estate tax payment trust will not be included in taxable income by the owner. To the extent that the newspaper business is held in corporate form, this payment would in all other cases be treated as a taxable dividend.

Third, the exemption of trust earnings is contrary to existing law which would normally, in this case, treat the beneficiary as the owner of the trust and taxable on its income.

Fourth, exclusion of the corpus of the trust from the owner's gross estate violates existing principles which would include in a decedent's estate any asset in which the decedent or his estate had an interest.

Finally, if it was appropriate to exclude the funding and earnings of the trust from the decedent's income, then the exclusion from estate income of the amount paid by the trust to relieve the estate of its estate tax liability contravenes the basic income tax rule that discharge of an obligation of another results in income to the party whose obligation has been discharged.

The proponents of this bill may argue that many of its provisions are analogous to provisions of existing law. For instance, there are provisions in the deferred compensation area dealing with business deductions, exclusions from income, tax-exempt trusts, and estate tax exclusions. But this is a poor analogy. First, in the employee plan area the law does not discriminate between industries or businesses. Second, although deductions are allowed at the business level, these deductions are allowed only insofar as they meet the "ordinary and necessary" standards of section 162 or 212. Third, although the employee participating in a retirement plan is not taxed currently as contributions are set aside for him by his employer, those amounts and their accumulated earnings are taxed to the employee, or his heirs, when received. Finally, the estate tax exclusion for certain employee benefits is limited to benefits payable as annuities and does not extend to lump-sum payments. Furthermore, this exclusion is specifically not applicable to the extent the payment is made to or for the benefit of the decedent's estate.

It has been suggested that special estate tax relief was granted in 1976 to family farmers and that this bill merely extends comparable benefits. This is not so. The special estate tax valuation provisions of Section 2032A relating to farm property contain substantial restrictions regarding the pre- and post-death family ownership and operation of the farm business, which are totally absent from this bill. Furthermore, the benefits of that section are limited to cases in which the farm interest is a major part of the estate.

Apart from its significant departure from accepted tax principles the bill has other deficiencies. The benefits are available to any shareholder of an independent "local" newspaper, no matter how many shares are owned and without regard to whether such ownership creates an estate tax liquidity problem. Moreover, there is no provision for the recapture of benefits if the family of the owner does not continue operating the local newspaper.

While we are sympathetic to the plight of some owners of small businesses in planning the payment of estate taxes while retaining control of their business in the heirs, we oppose this special relief for one group of "small businessmen." We well understand that these problems have in some cases increased following the enactment of the Tax Reform Act of 1976. In particular, there is now a greater likelihood of a significant income tax liability in the event that a business interest is sold to provide funds for the payment of estate taxes.

It must be noted, however, that present law already provides relief for small business owners and their heirs. Section 303 provides that in certain cases the

redemption of stock by a corporation to pay estate taxes will be treated as a redemption and thus subject to capital gains tax rather than as a dividend subject to ordinary income tax. Also, if a portion of the business must be sold to generate funds to pay estate taxes, the gain realized will generally be taxed at the capital gains rate. Further, the transaction can often be structured as an installment sale, in which case the payment of the income tax is deferred over the installment payment period.

In computing the estate tax, there are special relief provisions. In the 1976 Act, the amount of property which may be passed without being subject to the estate tax was increased from $60,000 to $175,000. Also, the marital deduction for transfers to surviving spouses, which before the 1976 Act was limited to one-half the estate, was changed to a limit of the greater of 50 percent of the value of the gross estate or $250,000.

Finally, the payment of the estate tax may be deferred where a business interest constitutes a major part of the estate. Under section 6161(a) the time for payment of the estate tax may be extended for up to 10 years upon a showing of reasonable cause. Reasonable cause exists when an estate consists largely of a closely-held business and does not have sufficient funds to pay the tax on time, or must sell assets to pay the tax at a sacrifice price. In section 6166 a five-year deferral and 10-year installment payment is allowed if the value of an interest in a closely-held business exceeds 65 percent of the adjusted gross estate. Finally, section 6166A is applicable to a broader number of situations, those in which the value of the closely-held business interest is either 35 percent of the gross estate or 50 percent of the taxable estate. Under that section the estate tax attributable to the closely-held business interest may be paid in up to 10 annual installments.

As valuable as a free and vigorous press is to this nation, we do not believe that an ownership interest in such business should be entirely free from tax. If the independent local newspaper industry has particular problems arising from its economic circumstances, the tax expenditure method may be one of the least controllable methods of dealing with them. Consideration should be given to other means of relieving the burdens of payment outside the framework of the tax laws. For instance, special loan programs might be considered. To the extent the value of these businesses is being artificially escalated by takeover bids from larger newspapers, the possible application or modification of the anti-trust laws should be considered.

The adoption of this bill would provide a wedge to be used again and again by other segments of society, each arguing its own importance. We do not believe in this piecemeal approach to legislation. There are existing provisions intended to minimize the problems inherent in the payment of taxes. If they are inadequate they should be reviewed in a comprehensive and not an ad hoc manner.

SUMMARY OF TREASURY POSITIONS

H.R. 810.—Reimbursement by certain private foundations of foreign travel expenses of government officials: Would not oppose if modified.

H.R. 4030.—Exception to tax on excess business holdings for holdings in certain public utilities: Opposed.

S. 2771.—Tax treatment of bingo income of exempt organizations: Would not oppose if modified.

H.R. 5099.—Relief under section 1034 for Mr. and Mrs. Hall: Opposed.

S. 3345.—Deficiency dividend procedure for Small Business Investment Companies: Not opposed. Would not oppose extending the deficiency dividnd procedure accorded real estate investment trusts by the Tax Reform Act of 1976 to all regulated investment companies.

S. 1611 and S. 3049.—Product liability self-insurance trusts: Opposed. The Administration recommends adopting a 10-year carryback for net operating losses attributable to product liability.

S. 3176.—Contributions in aid of construction to capital of electrical energy and gas utilities: Opposed.

S. 3341.—"The Independent Local Newspaper Act of 1978": Opposed.

APPENDIX

1. H.R. 4030

H.R. 4030 would create an exception to the tax on the excess business holdings of a private foundation in cases in which a private foundation owned over 40 per-

cent of the voting stock of a public utility which had taxable income of less than $1,000,000 during its first taxable year ending after May 26, 1969, and which meets certain other conditions. One of the basic goals of the 1969 Act was to eliminate the use of private foundations to maintain control of business enterprises. Foundation control of business interests had produced a number of undesirable results: competing businesses owned and operated by taxable entities were placed at a competitive disadvantage; benefits to charity were deferred through the accumulation of funds in controlled businesses; and foundation managers became primarily concerned with business affairs rather than with the charitable objectives of their foundations. A provision (section 4943) was added to the Code by Congress in 1959 to limit the involvement of private foundations in business enterprises by imposing a tax of up to 200 percent on the business holdings of private foundations in excess of certain prescribed percentages. The adoption of special exceptions to the excess business holding provisions would undermine one of the basic goals of the 1969 Act. While we recognize that an exception to the tax on excess business holdings for holdings by a private foundation in a public utility would not run counter to all of the arguments advanced for the adoption of the tax on excess business holdings (*e.g.*, a public utility operates as a regulated monopoly in a certain area and, therefore, does not "compete" with other business) we are, nevertheless, opposed to creating exceptions on an *ad hoc* basis to the limitations imposed by Section 4943. Regardless of the nature of the business controlled by the foundation and its donor or donors, there mere existence of foundation control inevitably tends to direct the foundation's efforts to operating the business and thus to divert attention from the charitable purposes of the foundation.

2. H.R. 5099—A bill for the relief of Brian and Vera W. Hall

Section 1034 of the Code provides for the nonrecognition of gain from the sale of a taxpayer's principal residence if the taxpayer purchases a new principal residence within a period beginning 18 months before the date of such sale and ending 18 months after such date.

H.R. 5099 would treat the sale of the Halls' former personal residence as if it had occurred within 18 months after they purchased their new residence for purposes of Section 1034 even though the sale of the former residence occurred almost 20 months after the purchase. The enactment of H.R. 5099 would thereby allow the Halls to avoid recognition of gain realized on the sale of the former residence, even though they did not comply with the requirements of Section 1034. It is contended that the Halls encountered difficulty in selling the former residence because of the construction of and controversy surrounding a highway project in the area which was opposed by local groups and after 18 years is not yet completed.

The statutory period aggregating 36 months provided for in Section 1034 is a reasonable time for a taxpayer to purchase a new residence. To override this statutory limitation for the benefit of two individuals would open the door to similar requests by other taxpayers. On the other hand, to waive the 36-month requirement only for these individuals would discriminate unfairly against similarly situated taxpayers who, because of failure to meet the requirement, paid tax on the gain realized on the sale of their residences.

It has also been suggested that because an extension of the reinvestment period under Section 1033 (involving involuntary conversions) is available, Section 1034 should also contain such an extension. However, in contrast with Section 1034, Section 1033 provides relief for those subjected to involuntary conversion of property rather than for individuals who voluntarily dispose of a residence. Persons selling residences can be expected to have more time for advance planning than those who are victims of involuntary conversion.

Moreover, even under the standards of Section 1033, it is unlikely that the Halls could have secured an extension. Revenue Ruling 76–488, 1976–2 C.B. 244 and Revenue Ruling 76–540, 1976–2 C.B. 245, hold that when reinvestment is delayed because of a sewer moratorium in the area of indefinite duration, "reasonable cause" does not exist for failure to reinvest the proceeds in a timely fashion under Section 1033. However, when a taxpayer can demonstrate that a moratorium of limited and specific duration has delayed reinvestment, an extension may be granted.

The project that delayed the sale of the Halls' former residence was of indefinite duration. It had been the subject of some controversy for 18 years, and there is no

indication that it is expected to be completed in the near future. This is not a circumstance which arose unexpectedly to thwart the Halls' sale of their residence. They had full and adequate notice regarding this controversial project.

Because of the inequities involved in granting the relief requested by the Halls, because of the differences between Section 1033 and Section 1034, and because the Halls may well have not qualified under the Section 1033 time extension standard in any event, the Treasury opposes H.R. 5099.

Senator BYRD. Thank you, gentlemen.

Mr. STEWART. Thank you, sir.

Senator BYRD. The next group to be heard in connection with S. 3176, is Mr. W. Dean Hudson, on behalf of the Edison Electric Institute, Mr. Ernest A. Becker, president of the National Association of Home Builders, and Mr. George H. Lawrence, president of the American Gas Association.

Mr. Hudson?

STATEMENT OF W. DEAN HUDSON, ON BEHALF OF THE EDISON ELECTRIC INSTITUTE

Mr. HUDSON. My name is William Dean Hudson. I am the manager of taxation for Southern Companies Services, Inc., which provides specialized service to the Southern Companies System, which includes the Alabama, Georgia, Gulf and Mississippi Power Cos. I am also the chairman of a task force of the Edison Electric Institute which wishes to address this problem.

This statement is filed on behalf of the Edison Electric Institute, a national association of U.S. investor-owner electric utilities, whose members comprise 99 percent of the investor-owned segment of the industry and supply 77 percent of all electricity users in the United States.

We endorse Senate bill 3176, which would amend section 118 of the Internal Revenue Code, to specifically conform the longstanding rule that contributions in aid to construction and amounts similarly treated, such as highway relocation reimbursements, do not constitute gross income to regulated electric utilities.

Under S. 3176, the amounts collected as contributions in aid of construction by electric and gas utilities would be treated as contributions to capital in the same manner that they are treated for water and sewage disposal utilities under the Tax Reform Act of 1976. The 1976 legislation and this amendment are made necessary by the Internal Revenue Service's change, in Revenue Ruling 75-557 of its prior treatment of such contributions.

Contributions in aid of construction are cash or other property received by a public utility to defray specific construction costs incurred on behalf of the contributor. Contributions are received for construction of facilities which normally would not be built with the utility's own funds, because the revenue to be earned would not justify the investment.

If the utility were to construct such facilities without the benefit of the contributions in aid of construction, the cost thereof would, in effect, be borne by its customers generally, rather than those for whom the facilities were constructed. For accounting and ratemaking purposes, most regulatory agencies require that contributions in aid of construc-

tion be credited to the same balance sheet accounts as those to which the construction costs are charged.

As a result, property constructed with such contributions does not increase the utility's rate base. In other words, the utility does not earn a profit from this particular piece of property. No investment credit or depreciation with respect to such property has traditionally been allowed by the Internal Revenue Service. S. 3176 is intended to continue this traditional treatment.

Since the 1920's, public utilities have received nonshareholder contributions in aid of construction without including them in income. The Internal Revenue Service acquiesced in a series of early cases which held that such contributions from customers to regulated public utilities do not constitute taxable income. The Service, in 1958, issued a ruling to this effect, and affirmed this treatment. In 1973, the Supreme Court issued its opinion in the *Chicago Burlington and Quincy Railroad* case, in which the Court described certain characteristics of nonshareholder contributions to capital.

And 2 years later, based upon this case, the Internal Revenue Service revoked Revenue Ruling 58-555, and issued Revenue Ruling 75-557 which held that connection charges for installing service from main lines to new customers of a regulated water company were thereafter to be regarded as taxable income and not contributions to capital. In essence, the ruling removes the regulated public utility factor as a basis for excluding contributions in aid of construction from taxable income.

Although the ruling deals specifically with connection charges of a water company, the Internal Revenue Service plans to apply the principles of this ruling to gas and electric companies. The problem created by the ruling is the fact that——

Senator BYRD [sounding the gavel]. Do you have much more in your statement?

Mr. HUDSON. I would like to summarize. The problem presented in this ruling is that it creates a serious inequity between water and sewage utilities and electric and gas utilities, increases the cost to the utility that will have to be borne by customers generally or the person causing the building of the facility, and results in even higher electric and gas rates.

Senator BYRD. Thank you, sir. Without objection, I will insert in the record at this point a letter from the Association of American Railroads, signed by Mr. William H. Dempsey, president and chief executive officer.

[The material referred to follows:]

ASSOCIATION OF AMERICAN RAILROADS,
Washington, D.C., August 24, 1978.

Hon. HARRY F. BYRD, JR.,
Chairman, Subcommittee on Taxation and Debt Management Generally, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: On behalf of the Association of American Railroads (AAR), I would like to register our support for the principles set forth in S. 3176, Senator Laxalt's bill to amend Section 118 of the Internal Revenue Code of 1954 to clarify the tax treatment of contributions in aid of construction to regulated electric or gas public utilities. For reasons set forth below, we strongly believe that this bill should be amended to make it clear that contributions in aid

of construction are not taxable income to recipient railroads who face similar tax problems.

The AAR is a voluntary, unincorporated, non-profit organization composed of member railroad companies in the United States, Canada, and Mexico. These railroad companies operate 92 percent of the line haul trackage, employ 94 percent of the workers, and produce 97 percent of the freight revenues of all railroads in the United States. The heavily regulated railroad industry believes that as a matter of tax equity it should be granted the same clarification as to the tax treatment of contributions in aid of construction as is provided in S. 3176 for regulated electric or gas public utilities. The tremendous current capital needs of the railroad industry have been emphasized in studies by the Department of Transportation, independent analyses, and by the railroad industry itself.

Section 118 of the Internal Revenue Code of 1954 excludes from income contributions to capital of corporations. Section 362(c) provides that in the case of such contributions to capital by a non-shareholder, the tax basis of assets received as such contributions or purchased with cash so contributed shall be zero. There is thus symmetry, and no tax windfall can result.

Prior to 1975, during a period extending nearly 50 years, the Internal Revenue Service (IRS) had followed a series of Tax Court cases holding that contributions in aid of the construction of facilities by a public utility or railroad did not result in taxable income to the recipient if the facilities are used to provide services to the contributor at rates subject to regulation by a regulatory body. In *United States v. Chicago, Burlington and Quincy Railroad Co.*, 412 U.S. 401 (1973), where the taxpayer was a railroad whose rates were subject to regulatory supervision, the Supreme Court held that government payments received for improvements at grade crossings and intersections were not contributions to capital under the Internal Revenue Code of 1939. The question in that case was as to tax basis, which was not barred for such contributions under the 1939 Internal Revenue Code as it is under the 1954 Code. As a result of this decision, the IRS reversed its longstanding position which had held that contributions in aid of construction of facilities by a public utility or railroad were not income. IRS issued Revenue Ruling 75–557, holding that a connection fee, which includes a construction charge for the installation of a sewer line and water meter that a new subdivision lot owner must pay to obtain water service, is includible in a public utility's gross income for transactions after January, 1976.

Rev. Rul. 75–557 was rejected by Congress as to its specific holding, for Congress in the Tax Reform Act of 1976 amended Section 118 to add special rules under which contributions in aid of construction of water or sewage disposal regulated public utility facilities are expressly excludible from income as contributions to capital. The Conference Committee Report says that no inference is to be drawn as to the proper treatment of contributions in aid of construction generally from the enactment of special rules for water or sewage disposal utilities.

Despite this "no inference clause", the Public Service Commission of Nevada in 1977 issued an opinion and order requiring Sierra Pacific Power Company to charge customers making contributions in aid of construction of its utility facilities an amount to cover the potential tax liability resulting from Rev. Rul. 75–557. This Nevada action shows that the problem posed by Rev. Rul. 75–557 was not fully eliminated by the Tax Reform Act of 1976.

Thus, it is clear that the problem posed by Rev. Rul. 75–557 is still there for other regulated industries. The question arises for railroads, both as recipients of contributions in aid of construction and as contributors to public utilities, in various projects. Grade crossing protection and separation projects are a major, though not the sole instance of railroads receiving contributions in aid of construction. It would be anomalous for the government to tax its own contribution to such projects. Railroad facilities are sometimes constructed by or at the cost of customers, and to the extent not reimbursed are contributions in aid of construction comparable to customer contributions to electric and gas and other regulated public utilities.

There would be no net revenue loss to the Treasury because the IRS position had been to the contrary for 50 years. Inclusion of railroads would be equitable because the capital needs of the railroad industry are at least as great as gas or electric utilities and its financial difficulties are well known. Because of the rigorous regulation of the rail industry, there would be no opportunity for abuse and, of course, there has been no evidence of any abusive practices under the

former IRS regulations. Accordingly, we urge that S. 3176 be approved with an amendment that wil include contributions in aid of construction to railroads whose rates are subject to regulation as being contributions to capital of corporations excluded from gross income under Section 118 of the Code.

We respectfully request that this letter be made a part of the record of the hearing before the Subcommittee on Taxation ad Debt Management Generally.

Respectfully submitted,

WILLIAM H. DEMPSEY.

Senator BYRD. The next witness will be Mr. Ernest A. Becker, president of the National Association of Home Builders. Welcome, Mr. Becker.

STATEMENT OF ERNEST A. BECKER, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, ACCOMPANIED BY ROBERT D BANNISTER, SENIOR STAFF VICE PRESIDENT, AND MARK FITZGERALD, ASSISTANT DIRECTOR OF CONGRESSIONAL RELATIONS, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. BECKER. Mr. Chairman, Senator Packwood, my name is Ernest A. Becker. I am a homebuilder from Las Vegas, Nev., and I am president of the National Association of Home Builders, and I appear today on behalf of more than 104,000 members. NAHB is the trade association of American homebuilders.

With me today are Robert D Bannister, NAHB's senior staff vice president, and Mark Fitzgerald, assistant director of congressional relations of NAHB.

Contributions in aid of construction affect the fees paid by NAHB members to utilities for installation of water, sewer, gas and electric facilities. Historically, these contributions have been exempt from taxation. In 1975, the IRS ruled such contribtuions as taxable income to utilities, and the utilities in turn doubled their charges to homebuilders. In 1976, the Tax Reform Act exempted contributions to water and sewer utilities from income.

The effect of the Tax Reform Act caused such contributions to the electric and gas utilities to double in many States, and builders must pay those additional fees to the utilities. The additional cost must be passed along to the home buyer, as one additional factor in the continuing increase in new home prices.

NAHB supports enactment of S. 3176 to treat contributions in aid of construction to electric and gas utilities as nontaxable. NAHB supports this legislation as one way to help reduce the increase in housing costs. Unnecessary fees and other costs related to construction are driving up housing costs, and more and more people are finding it difficult to purchase a new home.

S. 3176 would eliminate one unnecessary cost increase without major impact to the Treasury.

If there are any questions, I wuold be happy to answer them.

Senator BYRD. Thank you, Mr. Becker. Senator Packwood?

Senator PACKWOOD. No questions.

Senator BYRD. I note the distinguished Senator from Nevada has come into the room. I wonder if the Senator from Nevada would want to wait until the next witness.

Senator LAXALT. I think perhaps I would. Mr. Chairman. Thank you.

Senator BYRD. The next witness is George H. Lawrence, president of the American Gas Association.

STATEMENT OF GEORGE H. LAWRENCE, PRESIDENT, AMERICAN GAS ASSOCIATION

Mr. LAWRENCE. Thank you, Mr. Chairman.

The American Gas Association, representing some 300 gas distribution and transmission companies, strongly supports S. 3176, sponsored by your colleagues on this committee, Senator Laxalt and Senator Curtis.

First, we would like to point out that the House Ways and Means Subcommittee on Miscellaneous Revenue Measures has recently approved by unanimous vote of 6 to 0 companion legislation, H.R. 11741. Additionally, we would add that contributions to aid of construction and governmental relocation costs have been regarded as nontaxable by the IRS for over 50 years, and because no revenues have been collected, we contend that this legislation will not result in a net revenue loss to the U.S. Treasury.

I would like to depart from my prepared text and just explain briefly a couple of things, specifically, what this legislation in our view does not provide and what it does provide. Critics have confused contributions in aid of construction with connection fees and have accused this legislation as affecting individual residential home connection fees. That is not its intent. Under this legislation, such individual connection fees would remain ordinary income to the utility, just like other payments on an individual's gas bill. This legislation does not alter the tax treatment of contributions or of connection fees, it solely codifys existing practices.

This legislation is intended to include two basic categories of contributions. No. 1, the majority of our present contributions are received by governmental entities, specifically, States, cities, municipalities, that are requesting the relocation of gas lines, and in the case of our sister energy industry, electric lines, be relocated because of urban rehabilitation, because of city, street, or highway changes, et cetera. The governmental entity that requires the changes pays for the relocations costs.

The second major class of contributions are those the previous witness alluded to which are made by individual developers of residential subdivisions. To better understand this, we would like to point out that it may be economical or uneconomical to extend a gas utilities main to a certain residential development. Additionally different public service commissions have differing main extension policies. The obvious uneconomic extension would be one of 20 or 30 miles to one farmhouse. An obvious economic extension would be one of one-half mile to a residential subdivision of 5,000. In between, there exists many different categories. In cases in which the utility is not required by its public utility commission to extend the main extension without cost to the individual, the individual developer in many instances will make a contribution in aid of construction to the utility to assure

that it is economic to make that extension. In so requiring the developer to pay for the extension you are not putting the burden of that extension on all the other ratepayers that the utility serves.

If these contributions or governmental reimbursements are made subject to ordinary income tax treatment, it simply means that the governmental entity or the residential developer will have to pay approximately twice the amount presently collected and go through additional regulatory machinations.

As I testified earlier to full committee the electric and gas regulatory industries at this time have severe capital formation probelms. We have severe rate increase problems already, and this would be just one more pebble on the scale that we would have to add making increasingly complex the problems as we go before the commissions. AGA submits that the long-standing historical approach of not making these contributions subject to income taxation should be continued and should be codified. We would cite the recent example in which the Congress has made very clear with respect to fringe benefits that the IRS should not make these unilateral changes without actually coming back to the Congress and having the legislative intent made clear.

Thank you.

Senator BYRD. Thank you, Mr. Lawrence.

Senator Packwood?

Senator PACKWOOD. Mr. Lawrence, let me make sure I understand how this works. You are a gas company, and the homebuilder is going to put in 20 or 30 homes and needs a gas line.

Mr. LAWRENCE. Right.

Senator PACKWOOD. And you estimate that the gasline is going to cost roughly $1 million. Does the homebuilder make a deposit with the gas company for that amount and they proceed to build the gasline?

Mr. LAWRENCE. In some cases, that is essentially about how it would work. If it would be of such marginal economics that it would not be in line with the gas company's normal main extension policy of proved economic feasibility that the State commission approved, the subdivision builder would say: "I want to be sure gas comes in. To the extent that a developer does not comply with the approved main extension policy, I will make up the difference."

Senator PACKWOOD. If it is a regular main extension policy, does the gas company do it at its expense?

Mr. LAWRENCE. Yes.

Senator PACKWOOD. All right. Does the builder give you $1 million ahead of time, or is it given to you as you progress and the gas company progresses, extending or putting in the new line?

Mr. LAWRENCE. Senator, I think that would vary in line with individual regulatory commission policy which supervise and review all contributions collections. One of the contentions that has been levied against this legislation is that it could be subject to abuse. We feel that there is no such possibility because all of the money coming in as contributions is strictly accountable by regulated utilities and such contributions are all handled in conformance with the policies of the State regulatory commission.

I honestly think, and perhaps my electric colleagues could elaborate on this, but I honestly think there would be varying ways in which

this would be handled by different commissions. In some cases it might all be up front. In other cases, it might be parceled out.

Senator PACKWOOD. If it is up front, the only excess income you would have would be whatever you could earn off of that prior to spending it as you were constructing the line. Is that right?

Mr. LAWRENCE. That could be the case, yes.

Mr. HUDSON. There is no income involved in the situation. The dollars put up front or the progress payment are all applied to the construction of the facility.

Senator PACKWOOD. All are what?

Mr. HUDSON. All are used to construct the facility. There is no income related to this subject.

Senator PACKWOOD. There could be, if you get all the money up front, and it takes several years to build the line.

Mr. HUDSON. I agree with Mr. Lawrence that individual situations can occur, but theoretically if it took a long project, and I am familiar with a long—over several years—with many million of dollars, it would be a progress payment-type situation.

Senator PACKWOOD. I see Treasury opposes this. They estimate a loss of about $200 million.

Mr. HUDSON. We take the position since contributions have historically not been taxed, there is no revenue loss. The revenue figures are—we supplied figures to Treasury, and they were in the neighborhood of $100 million.

Senator PACKWOOD. I am not necessarily receptive to Treasury's figures. I am trying to understand what happens if Treasury's position prevails. If it is going to cost you $1 million to build the line; if the $1 million this builder provides you is counted as income and you have to pay a tax on it, in essence you will need to have the builder put up $1.5 million, pay the tax, and then lay the line. Is that correct?

Mr. LAWRENCE. I hear a dissenting voice to my left.

Mr. BECKER. The problem comes because you have to pay the $1 million, and then the tax, and then the tax is taxable because it is 50 percent, so if it is one-half a million, you have another $250,000——

Senator PACKWOOD. And the $500,000.

Mr. BECKER. So the builder would have to put up $2 million.

Senator PACKWOOD. I've got it, thank you. No more questions.

Senator BYRD. Senator Laxalt?

Senator LAXALT. I would just like to read a short statement, if I may.

Senator BYRD. Yes, take your time.

Senator LAXALT. I hope I am not covering ground which has previously been covered by these gentlemen. If I am, so be it.

First of all, I would like to thank the chairman and Senator Packwood for participating in these hearings today. We are theoretically in a recess period, so your being here, I think, is above and beyond.

I am delighted to see that you have decided to hold hearings on this bill, which is Senate bill 3176, which I introduced earlier in this session. Of course, the purpose is to clarify the Federal tax treatment of so-called contributions in aid of construction. I think, Mr. Chairman and Senator Packwood, this is an exceedingly important bill, and I urge its prompt consideration by the full committee.

In 1975, now, as a matter of history, IRS issued Revenue Ruling 75-557, which held that connection fees received by a public utility are includable in the utility's gross income and are taxable for that ruling whenever an individual or company applied to a utility for service to pay the utility to help defray the cost of construction to build the lines out to the new customers. The money paid was considered a contribution to capital. It has been indicated here this has happened really literally forever.

The utility paid no taxes on this contribution. The contributions were not included in the rate base. Under 75-557, any time a payment was made to a utility, whether to assist in establishing a new service or to relocate an old one, it is true, it applies in either case that payment must be included as taxable gross income.

As a result, utility companies have applied for a 92.3-percent increase in the amount they charge for new connections to cover the cost of actual construction, and to reach the point you are inquiring about, Senator Packwood, the 48-percent corporate tax rate applied to these funds.

New customers, particularly for homes, are especially hurt by this ruling. The cost of connection fees in Nevada, Mr. Becker will attest, has nearly doubled as a result of this ruling. For example, the U.S. Navy requested its Air and Pacific Power Co., which is one of our larger facilities out there, to extend service to serve a microwave station at San Marino, Calif. The cost was estimated at $175,000, but under the terms of 75-557, they were forced to request $337,000. The Southern Pacific Industrial Development Co. in 1977 decided to build an industrial park in Sparks, Nev. Because of 75-557, the cost of utilities to serve this devlopment will be increased from $1.2 million to $2.307 million, $1.6 million, from $2,439 an acre to $4,690 per acre.

In short, 75-557 discourages capital formulation and increases the cost of new building at a time of increasing costs and sluggish growth. Now, for those of us in Nevada, where we are beset with tremendous housing problems in both the Las Vegas and Reno areas, this is simply adding to the problem we have out there.

My bill, S. 3176, will largerly restore the tax code to what it was prior to the issuance of the ruling by amending section 118 of the Internal Revenue Code to confirm the long-standing rule that contributions in aid of construction and amounts similarly treated termed governmental relocation reimbursements do not constitute gross income to regulated gas and electric companies.

The tax treatment of such contribution was expressly negated by the Tax Reform Act of 1976, but only for water and sewage disposal public utilities. The purpose of my bill is to simply provide the same treatment for gas and electric utilities and thereby codify and confirm the historical treatment of these amounts as nontaxable.

Because these utilities traditionally have not been including these contributions as gross income, my proposal would not create a revenue loss to the U.S. Treasury. During its consideration, as chairman and Senator Packwood will recall, of the Tax Reform Act of 1976, the Finance Committee voted on May 20, 1976 to repeal IRS 75-557. Later the committee backed off and repealed the ruling only for water and sewage.

On the Senate floor, Senator Curtis tried to amend the bill to include electric and gas utilities. Speaking for Senator Long, the subcommittee chairman, Snator Byrd said at that time, "Probably this is an area that should be considered by Congress sometime," and at the present time there appears to be inadequate information as to the need for the amendment proposed by the Senator from Nebraska, and also inadequate facts as to just what the contributions in aid would cover.

The Curtis amendment was subsequently defeated 40 to 47, which even at that time, with a paucity of information, was a fairly tight vote.

Mr. Chairman, as I see it, failure to enact this bill could have serious adverse impact, tax liability successfully imposed by IRS on gas and electric utilities. Utility rates will have to be increased, thereby forcing all utility users to effectively subsidize new projects. However, if the liability is not recovered, by a general rate increase by the utility, the contribution rate in most cases will have to be approximately doubled to pay the tax liability on the contribution and still complete the construction work.

This is also not acceptable because it would lead to increases in funding costs to builders to insure utility services for new housing and make it increasingly difficult for the average American family to afford a new home.

Mr. Chairman, in view of all of these facts and the testimony that has been previously adduced from these witnesses, I urge prompt committee consideration for Senate bill 3176, and I thank the chairman.

Senator BYRD. Thank you, Senator Laxalt.

Would Mr. Halperin, the tax legislative counsel of the Treasury Department, care to comment on this legislation?

Mr. HALPERIN. Thank you, Mr. Chairman.

In contrast to the last bill that we discussed this morning, we agree that there is a real problem here. We think that section 118(b) which is in the law today with water and sewage utilities is incorrect and can permit substantial amounts of income to be received tax free. On the other hand, we also recognize that if there were full current taxation of so-called contributions in aid of construction, there could in certain circumstances be an overstatement of actual economic income which would either force utilities to find other means of financing these extensions or perhaps would require greater amounts to be collected from the home builders or the governmental units.

I am not necessarily sure you need to collect double. In the example Senator Packwood gave, if they had $1 million for pipeline and there was a current tax of $500,000 on that, if the $1 million is taxable, the utility gets a basis for depreciation and would reduce its taxes over the next period of time by that $1 million of depreciation, so what it needs to get in addition is enough money to be able to perhaps pay interest on the $500,000 it would have to borrow to pay that tax, and which it would then derive money out of the future depreciation deductions in order to pay off the loan.

So, I do not think it needs to double it, but it clearly does need to get some additional amount of account for that deferral of the tax benefit. The problem—and we have been trying to study the problem since it has been raised again over the last few months—is to draw a

line and decide which way to go. If section 118(b) were to be extended, we certainly do have a more complex tax law. We have to draw a line between what is a contribution in aid of construction and what is not, and we have been experiencing some difficulties along those lines in the case of the proposed regulations on water and sewage utilities.

We have to make sure that there is no return to the utility from this amount, and our experience in the flowthrough and normalization area is, that is not always so easy to do. You have to make sure that there is no profit, that the amount the utility gets is exactly its cost for this particular line. We have to make sure, as Senator Packwood suggested, that there is no investment of funds for a temporary period which produces some benefit to the utility.

So, all of these things require complex tax rules to solve. We also have to, if we want to make the tax rules ocrrect, to tax whatever actual economic income there is here, and I think we would have to weigh that against the need for this form of financing and the disruption it has caused to the utilities if they cannot engage in this form of financing.

We have been trying to get input on those matters. We are studying the issue, and we would hope that all interested parties would contact us and give us whatever information they have available on this issue. We are at the moment opposed to this legislation, but we do retain an open mind on it, and would hope to be able to study it further.

Senator BYRD. You seem to have made a good case for it in your opening comments, and then you wind up in opposition, and then you say you have an open mind. [General laughter.]

Mr. HALPERIN. It is not an easy solution, Mr. Chairman. There is something to be said on both sides. Section 118(b), as in the law today, does understate income. On the other hand, if it were not there and they would continue this form of financing, I think they can make a case that the tax law, by taxing what is in fact a payment for future services currently at the time it is received, does tax more than the actual economic income that has been earned.

To try to get some place in the middle and get the income measurement precisely correct is not an easy job. We have been trying to draw a line between trying to find out whether the advantages that the utilities seek is the fact that they are by not paying tax on contributions in aid of construction avoiding a fair share of the income tax burden, is that what they are seeking, or are they saying no, there are advantages in this form of financing which are important to the way utilities do business, even if the tax burden was precisely correct, even if there were not a tax advantage to that?

Now, if that is the case, I think we have to weigh that against the potential complexities in the tax law of trying to draw the line between the cases where they should properly be applied and those cases where they should not, and for that we would need to develop more information, I think.

Senator BYRD. Senator Laxalt?

Senator LAXALT. May I ask Senator Packwood to yield for a moment?

Senator PACKWOOD [Nods affirmatively.]

Senator LAXALT. Wouldn't there also be a consideration as to how it would affect the current housing industry? Would that not be a fac-

tor in the consideration, the policy consideration, or would you approach it purely on the tax grounds?

Mr. HALPERIN. No, I think it is important to see what kind of disruption it would cause if this kind of financing was interfered with. I think probably they would have to get more money from the builders as they suggested or they would have to finance this out of an ordinary means of financing, which means, I think, spreading the cost over all customers, and maybe it is fairer not to do that. That is something we need information on.

Senator LAXALT. Mr. Chairman, I think Mr. Becker is seeking to be heard.

Senator BYRD. Mr. Becker?

Mr. BECKER. There are thousands of builders just like me out there, who would like to absorb this fee, but find we must pass it on to the consumer. Somewhere along the line I think the IRS has to find out and the people in Washington have to find out that the builders and consumers out there have had it. You have to give consideration to whom we pass all of these fees on to—the home buyer.

Our industry is so over-regulated today that builders sometimes spend $7,000-plus on a $40,000 to $50,000 house just because of regulatory fees that are charged to us. These added costs all go to the consumer, the guy who buys the house. You raise the cost just $1,000 in California and you eliminate approximately 800,000 people from buying a house. I do not understand how back in Washington they can say that the contribution to the utility does not have to be doubled. because the utility in Reno, the Sahara Pacific, only charged 50 percent. And they had to double the contribution from the builder in order to have sufficient funds for construction. All of this is passed on to the consumer. Somewhere in here, I think we have to be concerned about the consumer because there are millions of people across the United States who are being regulated out of owning a home of their own.

Senator LAXALT. I think that is all I have.

Mr. LAWRENCE. Mr. Chairman, one brief addition. I think that regulated utilities are not interested in earning money on advance payments. We would like the longstanding IRS status quo of these contributions simply being made not taxable restored. I think what Mr. Halperin has suggested as a possible regulatory treatment of some of these capital accounts might or might not occur. I would point out that there are few things in regulatory history that are more complicated than how rate commissions treat Federal taxes. So, it would be vastly simpler to simply again restore the longstanding tax treatment rather than creating additional tax classifications.

As far as utility input is concerned, we have filed, as you know, extensive comments with the IRS and the Joint Committee on Taxation, and we look forward to oral presentation before Treasury on September 27 to further clarify any points they might have.

Senator BYRD. Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman. Good presentation.

Senator BYRD. Thank you, gentlemen.

Senator LAXALT. Thank you, gentlemen.

[The prepared statements of the preceding panel follow:]

STATEMENT OF THE EDISON ELECTRIC INSTITUTE

My name is W. Dean Hudson. I am the Assistant Comptroller of Southern Company Services, Inc. This statement is made on behalf of the Edison Electric Institute, a national association of United States investor-owned electric utilities whose members comprise 99 percent of the investor-owned segment of the industry and supply 77 percent of all electricity users in the United States.

ENDORSEMENT OF S. 3176

We endorse S. 3176, which would amend section 118 of the Internal Revenue Code, to specifically confirm the longstanding rule that contributions in aid of construction and amounts similarly treated, such as highway relocation reimbursements, do not constitute gross income to regulated electric and gas utilities. Under S. 3176, the amounts collected as contributions in aid of construction by electric and gas utilities would be treated as contributions to capital in the same manner as they are treated for water and sewage disposal utilities under the Tax Reform Act of 1976. The 1976 legislation and this amendment are made necessary by the Internal Revenue Service's change in Revenue Ruling 75-557, 75-2 C.B. 33, of its prior treatment of such contributions.

INTRODUCTION

Contributions in aid of construction are cash or other property received by a public utility to defray specific construction costs incurred on behalf of the contributor. Contributions are received for construction of facilities which normally would not be built with the utility's own funds because the revenue to be earned would not justify the investment. If the utility were to construct such facilities without the benefit of the contributions in aid of construction, the cost thereof would, in effect, be borne by its customers generally, rather than those for whom the facilities were constructed.

Contributions generally are made pursuant to written contracts which set forth the cost of the particular facility. The utility is compelled by contract and regulatory requirements to use the contributions solely for construction of the facility. For accounting and rate making purposes, the Federal Energy Regulatory Commission (formerly the Federal Power Commission) and most state regulatory agencies require that contributions in aid of construction be credited to the same balance sheet accounts as those to which the construction costs are charged.

As a result, the property constructed with such contributions does not increase the utility's rate base. Thus, the utility does not earn a return on the property. No investment tax credit or depreciation with respect to such property has traditionally been allowed by the Internal Revenue Service. S. 3176 is intended to continue this traditional treatment.

HISTORY

Since the 1920's, public utilities have received non-shareholder contributions in aid of construction without including them in income. The Internal Revenue Service acquiesced in a series of early cases[1] which held that such contributions from customers to regulated public utilities do not constitute taxable income.

In the late 1950's, the Tax Court in *Telescrvice Co. of Wyoming Valley* v. *Commissioner of Internal Revenue*, 27 T.C. 722 (1957), aff'd 254 F.2d 105 (3rd Cir. 1958), held that in the case of a service company that was not a regulated utility, contributions in aid of capital construction were taxable income, basing in part that holding on a Supreme Court case (*Detroit Edison Co.* v. *Commission of Internal Revenue*, 319 U.S. 98 (1943)) dealing with the related issue of depreciation on property contributed by a non-shareholder. The Internal Revenue Service issued, in 1958, a ruling (Rev. Rul. 58-555, 1958-2 C.B. 25) affirming

[1] *Appeal of Liberty Light & Power Co.*, 4 B.T.A. 155 (1926); *Great Northern Railway Co.* v. *Commissioner of Internal Revenue*, 8 B.T.A. 225 (1927); *Rio Electric Co.* v. *Commissioner of Internal Revenue*, 9 B.T.A. 1332 (1928); *El Paso Electric Railway Co.* v. *Commissioner of Internal Revenue*, 10 B.T.A. 79 (1928); *Wisconsin Hydro-Electric Co.* v. *Commissioner of Internal Revenue*, 10 B.T.A. 933 (1928); *Tampa Electric Co.* v. *Commissioner of Internal Revenue*, 12 B.T.A. 1002 (1928); *Kauai Railway Co.* v. *Commissioner of Internal Revenue*, 13 B.T.A. 686 (1928): and *The Baltimore and Ohio Railroad Co.* v. *Commissioner of Internal Revenue*, 30 B.T.A. 194 (1934).

that contributions in aid of construction to regulated public utilities were contributions to capital and not taxable income. In Rev. Rul. 58-555, the Internal Revenue Service announced that any future change in its position would be prospective only.

In 1973, the Supreme Court issued its opinion in *Chicago, Burlington and Quincy Railroad* v. *United States*, 412 U.S. 401 (1973), again involving depreciation deductions (for property contributed to a railroad), in which the court described the characteristics of a non-shareholder contribution to capital. Two years later, based upon this case, the Internal Revenue Service announced the revocation of its 1958 ruling regarding the inclusion in income of nonshareholder contributions to utilities, effective after February 1, 1976, and ruled (Rev. Rul. 75-557) that connection charges for installing service from main lines to new customers of a regulated water company were thereafter taxable income and not contributions to capital. In essence, Rev. Rul. 75-557 removes the regulated public utility factor as a basis for excluding contributions in aid of construction from taxable income. Although Rev. Rul. 75-557 deals specifically with connection charges of a water company, the Internal Revenue Service is applying the principles of the ruling to a broad range of contributions in aid of construction (including contributions to electric and gas companies).

1976 TAX LEGISLATION

Section 2120 of the Tax Reform Act of 1976 amended section 118 of the Code to provide that contributions in aid of construction to a water or sewage disposal utility which are used for qualified expenditures and which are not included in rate base for rate making purposes are to be treated as nontaxable contributions to capital.

This provision had its genesis in the Senate Committee on Finance and originally provided generally that such contributions to all public utility corporations would be excludable from gross income. The Senate Committee on Finance later decided to limit this exclusion to water and sewer utilities.

PROBLEM CREATED BY REVENUE RULING 75-557

Under the Internal Revenue Service's new position, electric and gas utility companies would have to pay income tax on contributions in aid of construction in the year received. The utility would be entitled to claim depreciation and investment tax credits. In terms of absolute dollars, when the income tax reductions associated with the investment tax credit and the future depreciation are fully realized, the utility would be at least even and possibly ahead. However, in terms of present day dollars, the utility's cost would be increased because there would be an immediate tax outlay and only a later tax benefit. The cost of financing the tax would be paid by either the customer who made the contribution or by customers generally, present or future.

REVENUE IMPACT

Since contributions in aid of construction and relocation costs have been regarded as nontaxable for over 50 years, S. 3176 results in no net revenue loss to the United States Treasury. The bill only codifies the historic treatment of these amounts as nontaxable for electric and gas utilities.

SUMMARY OF CONCLUSIONS

Failure to treat contributions in aid of construction as contributions to capital will result in:

1) a serious inequity between water and sewage disposal utilities, and electric and gas utilities, and

2) either higher electric and gas rates or an increase in the amount of contributions so that the after tax amount will be adequate to pay for the facility that is involved.

STATEMENT OF THE NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. Chairman and Members of the Subcommittee: My name is Vondal S. Gravlee, and I am a home builder from Birmingham, Alabama. I am testifying

today on behalf of the more than 163,000 members of the National Association of Home Builders (NAHB), the trade association of the Nation's home building industry, of which I am first Vice President and the Chairman of the Committee on Federal Governmental Affairs. Accompanying me today is Robert D. Bannister, Senior Staff Vice President of NAHB, and Arthur Schreiber of Silverstein and Mullens, NAHB's Tax Counsel.

I appear before you today to express NAHB's strong support for enactment of S. 3176, introduced by Senator Laxalt, which would amend section 118(b) of the Internal Revenue Code to clarify the treatment of contributions in aid of construction received by regulated electric or gas public utilities.

For many years, builders in certain parts of the United States have been required to contribute funds to public utilities for the construction and installation of facilities to provide utility services to new housing developments. The facilities include main water or sewer lines, electric lines, and gas mains as well as the plants from which the gas, electricity, or water is transmitted. Typically, such contributions have been required of builders by the utilities in order to extend utility service to housing developments which are either a long distance away from the utility's existing facilities or are in previously undeveloped areas. In turn, our members have generally passed on the cost of such contributions to purchasers of the new homes which will benefit from the utility services.

Historically, the public utilities did not include the contributions received from builders and other customers in income, but instead treated such amounts as contributions to capital which were excludible from income. However, in 1975, the Internal Revenue Service published a ruling (Revenue Ruling 75-557) which had the effect of treating such contributions as taxable income to the utilities. It was quite obvious to NAHB that the effect of such Ruling was that the uilities would significantly increase the amount of contributions required of builders in order to provide the funds to pay such new Federal income tax liability. This in turn would further increase the cost of new housing by virtue of the builders passing on such additional cost to the home buyers.

In order to prevent such result, NAHB supported the efforts of the public utilities in 1976 to amend the Code to treat contributions received by utilities from builders and other customers as non-taxable contributions to capital. Congress responded to such efforts by adding section 118(b) to the Code as part of the Tax Reform Act of 1976 to treat as non-taxable contributions to capital amounts received as contributions in aid of construction by a regulated public utility which provides water or sewerage disposal services.

Congress, however, failed to provide similar treatment for contributions in aid of construction received by gas or electric utilities. As a result, the likelihood that the Internal Revenue Service will seek to tax gas and electric utilities on such contributions still remains. Many of our members are required to make substantial contributions in aid of construction to gas and electric utilities, and we see no logical reason to distinguish between water and sewerage disposal utilities on one hand and gas and electric utilities on the other hand for purposes of the tax treatment of contributions in aid of construction.

NAHB thus supports enactment of S. 3176 which would amend section 118(b) of the Code to treat as non-taxable contributions to capital the contributions in aid of construction received by a public utility which provides electric energy or gas. Such legislation would result in equality of tax treatment of the types of utilities in question with respect to contributions in aid of construction. We submit that the failure to enact such legislation will result in an unnecessary increase in the cost of new housing which will further worsen the extremely difficult situation facing potential home buyers. This results from the fact that our skyrocketing rate of inflation has so drastically increased the cost of new housing as to prevent many American families from purchasing their own home.

The median sales price of a new single family home has gone from $32,500 in 1973 to $57,300 in June of 1978. Between April and June alone the median price increased $4,200. From a year ago the percent increase is 17.7.

A recent study commissioned by the California Building Industry Association (CBIA) found that almost one-half (48.5%) of all California families cannot afford to buy even the least expensive new house without making substantial sacrifices. Individuals with incomes below the median level ($15,000) have to spend three to four times their annual income to purchase new homes. The study established that for every $1,000 increase in the price of the least expensive house ($37,000) approximately 100,000 families are effectively priced out of the market.

In view of the long-standing Congressional policy of encouraging home ownership, imposition of taxation on contributions in aid of construction received by gas or electric utilities would clearly be counter-productive to the achievement of this policy. NAHB therefore strongly supports enactment of S. 3176 in order to preclude the taxation of contributions in aid of construction received by gas and electric utilities, thereby producing a result identical to that provided under section 118(b) for water and sewerage disposal utilities. We endorse the position of the gas and electric utilities as presented before this Subcommittee on S. 3176 and urge that you approve such legislation as a means of holding down the rising cost of new housing which has prevented the dream of home ownership from becoming a reality for many millions of Americans.

I thank you for the opportunity to appear before this Subcommittee to present NAHB's views on this important legislation. I stand ready to answer any questions which you may have with respect to my statement.

Statement of George H. Lawrence, President of the American Gas Association

I am George H. Lawrence, President of the American Gas Association. On behalf of the American Gas Association, which represents some 300 natural gas distribution and transmission companies serving over 160 million U.S. consumers, we are pleased to provide you our industry's views on S. 3176 and the need to clarify the tax treatment of contributions in aid of construction to regulated gas or electric public utilities.

Summary of A.G.A. Position

A.G.A. strongly supports this legislation, and urges its prompt enactment into law during this session of the Congress. We note that the House Ways and Means Subcommittee on Miscellaneous Revenue Measures has unanimously approved companion legislation on contributions in aid of construction (H.R. 11741). We also emphasize that since contributions in aid of construction and governmental relocation costs have been regarded as non-taxable for over fifty years, this legislation results in no net revenue loss to the U.S. Treasury. The tax treatment of "connection fees" would remain unchanged under this legislation, and they would continue to be taxable currently.

Prompt Congressional approval of this bill would also provide the following national benefits:

S. 3176 only provides equitable tax treatment of these amounts collected by gas and electric utilities on a comparable basis with current treatment afforded water and sewerage disposal utilities.

Rate increases caused by unfavorable tax treatment of these amounts collected by these utilities could be avoided and all utility customers would not be forced to effectively subsidize these projects.

This bill avoids the only alternative which is to approximately double the contribution amount to provide sufficient funds to pay the tax liability on the contribution.

This bill avoids inflationary cost increases in the prices of new housing and also public projects that require the relocation of utility facilities.

IRS changes in law regarding this issue without seeking Congressional approval through the legislative process would be clarified.

Congress has seen fit to prevent this from occurring in the area of taxation of fringe benefits, and we urge Congress to exercise this same approach by promptly enacting S. 3176 into law.

Introduction and Definition of Terms

Generally, contributions in aid of construction are payments by the customers of a public utility for all or a portion of specific construction costs incurred to extend service providing gas or electric energy in excess of a prescribed standard established by the applicable state regulatory commission. Typically, they are payments made to extend utility service long distances or into isolated areas where use of the utility's own funds would not be justified from the standpoint of return on investment. If the facilities were built without receipt of any con-

tributions in aid of construction, the cost of such facilities would be borne in part by customers who receive no service or benefits from them.

Utilities also receive reimbursements from government agencies for costs incurred in relocating their facilities to accommodate governmental projects. Typically, the government agency will decide to construct or relocate a governmental facility, such as a building, a major highway, an access road, an overpass, an underpass, etc., which will require the utility to move its lines and equipment. Reimbursements utilities receive for this work also have traditionally been excluded from gross income in a manner similar to the treatment of contributions in aid of construction.

TAX/ACCOUNTING TREATMENT AND ADDITIONAL FEATURES

Customer contributions in aid of construction have historically been treated as contributions to capital, and not income. Therefore, they have not been taxable under Section 118 of the Internal Revenue Code. Reimbursements utilities receive from governmental entities for costs incurred to relocate their facilities to accomodate Federal or state government projects also have traditionally been excluded from gross income.

However, A.G.A. emphasizes that customer connection or reconnection fees, that is, payments made by a customer to have utility service turned on or off or to have service supplied within normal prescribed limits, have not been excluded from income by the gas and electric industry. These fees are taxable as income, and no change in treatment of these types of fees is contemplated by S. 3176.

Contributions in aid of construction also have the following additional features:

The utility is compelled by contract and regulatory requirements to use the contributions received solely for construction of the facility. Rules of both the Federal Regulatory Commission and of most state regulatory agencies require this result.

The property constructed for customers with such contributions is not depreciated for book purposes and is excluded from rate base. The utility cannot earn a rate of return on such property.

No investment tax credit or depreciation is allowable for Federal income tax purposes with respect to such property.

HISTORY

For almost 50 years, contributions in aid of construction to regulated public utilities have been excluded from gross income and treated as contributions to capital. In 1958, the U.S. Court of Appeals held in *Teleservice Company* v. *Commissioner of Internal Revenue* (254 F. 2d 105 (3rd Circuit, 1958)) that "contributions" received from customers of a service company that was not a regulated utility "for the total cost of constructing" facilities constituted taxable income currently, and that the basis of the property could not be reduced. As a resul of industry filings, the IRS issued Revenue Ruling 58–555 (1958–2 C.B. 25), which held that the *Teleservice* decision would not be applied to the regulated public utility industry. IRS also indicated in this ruling that any change of position would not be applied retroactively.

In 1973, the Supreme Court issued its opinion in *Chicago, Burlington and Quincy Railroad* v. *United States*, 412 U.S. 401 (1973), which involved depreciation deductions (for property contributed to a railroad). In that decision, the Court described five characteristics of a non-shareholder contribution to capital, which are:

(1) it must become a permanent part of the transferee's working capital structure;

(2) it may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee,

(3) it must be bargained for;

(4) the asset transferred foreseeably must result in benefit to the transferee in an amount commensurate with its value; and

(5) the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

Following that Supreme Court decision, the IRS issued on December 4, 1975, Revenue Ruling 75–557 (1975–2 C.B. 33), which revoked Revenue Ruling 58–555. That ruling held that connection charges for installing service from main lines

to new customers of a regulated water company were taxable income, and not contributions to capital. Although this ruling deals specifically with connection charges of a water company, it has been misconstrued to change this long-standing historical tax treatment of contributions in aid of construction received by gas and electric utilities.

The Tax Reform Act of 1976 (P.L. 94-455) eliminated this threat only for regulated public utilities providing water or sewerage disposal services. Specifically, Section 2120 of that Act amended Section 118 of the Internal Revenue Code to provide that contributions in aid of construction to a water or sewerage disposal utility which are used for qualified expenditures and which are not included in rate base for ratemaking purposes are to be treated as nontaxable contributions to capital.

The applicability of Revenue Ruling 75-557 to other utilities has not been resolved, but the Internal Revenue Service is now asserting its application to gas and electric utilities. In this regard, A.G.A. emphasizes that the Conference Committee report on the Tax Reform Act of 1976 made clear that:

"In providing these special rules for water and sewerage disposal companies, the conferees intend that no inference should be drawn as to the proper treatment of such items by companies which are not water or sewerage utilities." (Conference Report, Tax Reform Act of 1976, H. Rept. 94-1515, September 13, 1976, p. 502; also refer to comparable language in Senate Finance Committee Report, S.Rept. 94-938, June 10, 1976, p. 436, and the *General Explanation of the Tax Reform Act of 1976*, prepared by the staff of the Joint Committee on Taxation, December 29, 1976, p. 638.)

REVENUE EFFECT OF S. 3176

Since contributions in aid of construction and relocation costs have been regarded as non-taxable for over fifty years, this legislation results in no net revenue loss to the U.S. Treasury. The legislation only codifies the treatment of these amounts as non-taxable for gas and electric utilities, since historically, these amounts have not been included in income currently. The treatment of "connection fees" would remain unchanged under this legislation, and they would continue to be taxable currently.

NATIONAL BENEFITS OF CLARIFYING TAX TREATMENT OF CONTRIBUTIONS IN AID OF CONSTRUCTION

For the Subcommittee's use, A.G.A. has attached to this statement a detailed legislative summary of S. 3176 which discusses the exact changes in Section 118 of the Internal Revenue Code contained in this proposed legislation. (See Attachment 1) We urgently request the Subcommittee to recommend to the full Senate Finance Committee the prompt enactment of S. 3176 into law.

Prompt approval of this bill would provide the following national benefits.

EQUITY

This bill only seeks equitable tax treatment of these amounts collected by gas and electric utilities on a comparable basis with current treatment afforded water and sewerage disposal utilities. This is appropriate and necessary to avoid broad application by the IRS of Revenue Ruling 75-557 to a wide number of these contributions received by gas and electric utilities.

AVOID RATE INCREASES FOR UTILITY CUSTOMERS

Rate increases caused by this unfavorable tax treatment could be avoided and all utility customers would not be forced to effectively subsidize these projects. Historically, these amounts were never included in the utility's rate structure, and therefore, were never grounds for increasing customer rates. To the extent the potential tax liability is not reimbursed by increasing the amount of the contribution, utility rates would have to be increased to pay for the tax.

The alternative is to approximately double the contribution amount to provide sufficient funds to pay the tax liability on the contribution and to complete the construction work. It is impossible to develop beyond this with any precision a calculation regarding the exact percentage to which a contribution would have to be "grossed up" to provide the natural gas utility with the same approximate dollars after taxes (assuming, without conceding, the contribution to be taxable)

that it presently collects. A responsible, definitive percentage cannot be calculated because of unknown future decisions and positions of 50 different state regulatory commissions on this matter (including, for example, possible related effects of the inclusion or exclusion of the amounts in gross revenue, the utility's effective tax rate, the rate of return, the useful life for depreciation purposes of the property in question, the rate and specific regulatory treatment of investment credit, the time value of money, and other relevant considerations).

Most state commissions have not been faced with this issue before, and there is no precedent to draw upon. To the best of A.G.A.'s knowledge, only two state regulatory commissions have acted on this issue to date. We understand that Connecticut currently requires $2.27 for each $1 contribution collected (an additional $1.27), and that Missouri has recently issued an order in one case that would require $2 for each $1 contribution collected (an additional $1.00). Such action may be indicative of what other commissions will require.

CUTBACK OF COSTS FOR NEW HOUSING AND PUBLIC PROJECTS

Almost doubling the contribution amount is an unacceptable alternative, since it will drive up the costs of new housing and also public projects that require the relocation of utility facilities. Contributions in aid of construction are frequently encountered by homebuilders of new subdivisions and units in expanding suburban areas. If contributions are treated as taxable income to the utility, the burden of these additional costs falls on contractors, homebuilders, and developers who are required to pay substantially higher front-end and development costs. It would be counterproductive for the Federal government to further aggravate the cost spiral in the construction and homebuilding industry by considering contributions in aid of construction as gross income to regulated gas and electric utilities. Such a result makes it more difficult for the average American family to afford the purchase of a new home.

Further, taxing governmental relocation costs received by these utilities is inequitable when considering these relocations are performed at the request of the governmental entity. Such tax treatment would also increase the cost of public projects that require the relocation of utility facilities.

Generally, statutes authorizing many of these public projects authorize these payments to utilities to eliminate the delay and added costs that would result if the utility elected to force the use of public condemnation actions to effect such relocations (See, for example, The Federal Highway Act, 23 U.S.C. § 123). Broad application of Revenue Ruling 75–557 could be characterized as causing a net loss to the Federal Treasury by requiring a significant increase in the Federal payments obligated under various federal programs to cover the gross-up factor, if the amounts are treated as gross income. Thus, IRS application of this Ruling to these types of payments is contrary to Congressional policy previously reflected in several federal programs, such as the Federal Highway Act, the Urban Mass Transit Program, and the Urban Redevelopment Program.

AVOIDS IRS CHANGE IN LAW WITHOUT SEEKING LEGISLATION

S. 3176 also clarifies the change in law initiated by the IRS without seeking Congressional approval through the legislative process. Most recently this problem caused by IRS administrative actions has been raised in the context of discussion regarding tax treatment of certain fringe benefits to individual taxpayers. The Congress has seen fit to prevent this from occurring, and we urge the Congress to exercise this same approach by promptly enacting S. 3176 into law to clarify the tax treatment of these amounts collected by gas and electric utilities.

We thank the Subcommittee for the opportunity to submit this written statement.

AMERICAN GAS ASSOCIATION,
Arlington, Va.

LEGISLATIVE ANALYSIS

EXECUTIVE SUMMARY

This bill amends Section 118 of the Internal Revenue Code to specifically confirm the long-standing rule that contributions in aid of construction and amounts similarly treated, termed as highway relocation reimbursements, do not constitute gross income to regulated gas and electric utilities.

These amounts collected by gas and electric utilities would be treated as contributions to capital in the same manner as they are treated for water and sewerage disposal utilities.

Section 1. In general

Amends Section 118(b) of the IRC as follows:

(a) by striking out "water" in paragraph (1) which precedes subparagraph (A) and inserting "electric energy, gas (through a local distribution system or transportation by pipeline), water";

(b) by striking out "water" in paragraph (1)(B) and inserting in its place "electric energy, gas, steam, water"; and

(c) by striking out "water" in parargaph (2)(A)(ii) and inserting in its place "electric energy, gas, steam, water."

Comment.—These provisions in (a) and (b) ensure that the general rule contained in Section 118(a) of the IRC (excluding from gross income any contribution to the capital of the taxpayer) will apply to gas and electric utilities as well as water and sewerage disposal utilities. Provision (c) ensures that the expenditure rule in Section 118(b)(2) covers amounts expended for the acquisition or construction of tangible property which is used predominantly in the trade or business of furnishing electric energy, gas, steam as well as water or sewerage disposal services.

(d) By striking out "property" in paragraph (3)(A) and by inserting in its place "line" and by striking out "a main water or sewer line" in paragraph (3)(A) and inserting in its place "an electric line, a gas main, a steam line, or a main water or sewer line".

Comment.—This provision clarifies the definition of contributions in aid of construction in regard to amounts collected by the gas and electric utilities.

(e) amends paragraph (3)(C) to read as follows:

(C) Regulated public utility.—The term "regulated public utility" has the meaning given such term by Section 7701(a)(33); except that such term shall not include any such utility which is not required to provide electric energy, gas, water, or sewerage disposal services to members of the general public (including in the case of a gas transmission utility, the provision of gas services by sale for resale to the general public) in its service area.

Section 2. Effective date

These amendments shall apply to contributions made after January 31, 1976.

ANALYSIS

In general, contributions to capital of a corporation are not income and, therefore, are not taxable under Section 118(a). The Tax Reform Act of 1976 (P.L. 94-455) confirmed this treatment for regulated public utilities providing water or sewerage disposal services as long as the contributions or property purchased with these amounts are not included in the utility's rate base for ratemaking purposes. However, Congress failed to confirm the tax treatment of contributions in aid of construction for gas and electric utilities. It now appears that the Internal Revenue Service will not treat these contributions to gas and electric utilities as contributions to capital in the same manner as water and sewerage disposal utilities.

Generally, contributions in aid of construction are payments by the customers of a public utility for all or a portion of specific construction costs incurred to extend service providing gas or electric energy (including steam) in excess of a prescribed standard established by the applicable regulatory commission. Typically, they are payments made to extend utility service long distances or into isolated areas where use of the utility's own funds would not be justified from the standpoint of return on investment. If the facilities were built without receipt of any contributions in aid of construction, the cost of such facilities would be borne in part by customers who receive no service or benefits from them.

Reimbursements utilities receive from government agencies for costs incurred in relocating their facilities to accommodate governmental projects also have traditionally been excluded from gross income in a manner similar to the treatment of contributions in aid of construction. However, customer connection or reconnection fees i.e., payments made by a customer to have utility service turned on or off or to have service supplied within normal prescribed limits, have not been excluded from income by the gas and electric industry. These

fees are taxable as income, and no change in the treatment of connection fees is contemplated by this legislation.

Contributions in aid of construction have the following additional features:

The utility is compelled by contract and regulatory requirements to use the contributions received solely for construction of the facility. Rules of both the Federal Energy Regulatory Commission and of most state regulatory agencies require this result.

The property constructed for customers with such contributions is not depreciated for book purposes and is excluded from rate base. The utility cannot earn a rate of return on such property.

No investment tax credit or depreciation is allowable for Federal income tax purposes with respect to such property.

For almost fifty years, contributions in aid of construction to regulated public utilities have veen excluded from gross income and treated as contributions to capital. The Internal Revenue Service issued Revenue Ruling 75-557, 1975-2 C.B. 33, on December 4, 1975, which could be misconstrued to change this long-standing historical treatment. The Tax Reform Act of 1976 eliminated this threat only for regulated public utilities providing water or sewerage disposal services. The applicability of this ruling to other utilities has not been resolved, but the Internal Revenue Service is now asserting its application to gas and electric utilities.

Failure to treat these payments as contributions to capital will create a serious inequity between water and sewerage disposal utilities and gas and electric utilities. To the extent the tax liability is not reimbursed by increasing the amount of the contribution, utility rates will have to be increased to pay for the tax, which would effectively force all utility customers to subsidize these projects. The alternative is to approximately double the contribution amount to provide sufficient funds to pay the tax liability on the contribution and to complete the construction work. However, this alternative is unacceptable because it will drive up the costs of new housing and also public projects that require the relocation of utility facilities.

Since contributions in aid of construction and relocation costs have been regarded as non-taxable for over fifty years, this legislation results in no net revenue loss to the U.S. Treasury. The proposal only codifies the historic treatment of these amounts as non-taxable for gas and electric utilities.

Senator BYRD. The next bill to be considered is S. 3441, introduced by the Senator from North Carolina, Mr. Morgan. The Senator from Virginia will disqualify himself from considering this proposed legislation. The Senator from Oregon, Mr. Packwood, will assume the chairmanship of this committee.

Senator PACKWOOD (presiding). Senator Morgan, please proceed.

STATEMENT OF HON. ROBERT MORGAN, A U.S. SENATOR FROM THE STATE OF NORTH CAROLINA, ACCOMPANIED BY MORRIS J. LEVIN, ESQ., JOHN SIEGENTHALLER, AND ALFRED POLLARD

Senator MORGAN. Mr. Packwood, I want to thank you for agreeing to hear us on this bill, which I consider to have some urgency about it, but before I proceed with it, Mr. Chairman, I would like to introduce those accompanying me at the table this morning. We have Mr. Morris Levin, who is sitting on my right, who represents the Independent Local Newspaper Association, and Mr. John Siegenthaller, who is the publisher of the Nashville Tennessean, and on my left is Alfred Pollard of my staff.

I have a prepared statement which I will submit and ask that it be made a part of the record.

Senator PACKWOOD. It will be put in the record.

Senator MORGAN. Then I would like to talk briefly and yield to the gentlemen who are with me concerning this bill.

Mr. Chairman, years ago, when I was attorney general of North Carolina, I became aware of the acquisition of a number of newspapers in my State by out-of-State chains, and I became concerned about it, and began to look at it generally and casually, not in depth. We explored the possibilities of antitrust laws, but we realized then as I do now that that would be difficult, if not impossible, even if it were desirable to amend antitrust laws, but since I have been in Congress, I have been concerned about the continued acquisitions of newspapers by many of the major chains across the Nation.

Attached to the statement or to the introduction of the bill in the Senate is an article from U.S. News & World Report which appeared in August of 1977, which points out that I believe 72 percent of all daily newspaper circulation in this country today is by major newspaper chains, and the list of papers that are being acquired is growing so fast, Mr. Chairman, that I find that the list of those in North Carolina owned by major chains which we prepared at the end of last year is already outdated.

For instance, in North Carolina alone, the New York Times owns three of the larger daily newspapers. It owns the Hendersonville paper, the Lexington paper, and also the Wilmington, N.C., daily newspaper, and just a couple of weeks ago I was in North Carolina, in Wilmington, on a Monday afternoon, and I happened to pick up a Wilmington paper, and the first section of that paper was composed of 8 or 10 pages, and was either wire service news or some local stories interspersed, but the entire second section was a reprint of summaries from the New York Times on Sunday.

Now, it frightens me, because I think that a free press and an independent press is a necessity for really the survival of our Democratic way of life. There are times when I almost wish there were not any press, but yet I realize that without the press being independent and free to probe and to watch our system of Government probably would not have survived long enough for me to be a part of it, but one of the reasons that many of these papers are being sold to major chains is because of the estate taxes that the families would have to pay in the event of death.

Let me just read part of a letter to you from Ashley Futrell, who is the editor of the Washington Carolina Daily newspaper. I served in the State senate with Ashley for a long time, but I think he states his case much better than I can. He savs, Mr. Chairman, that, "The situation today is almost unbelievable. Here in the coastal area of our State, there are only four daily newspapers still locally owned and locally operated," and when he says the coastal area, he is talking about from Raleigh east, which is about half of the State, 250 or 300 miles. "There are only four daily newspapers still locally owned and operated, which really dare to care about the local community, the Washington, Greenville, Tarboro, and Wilkinson. If you look at the map," he says, "you will see that we have a horseshoe of chain daily newspapers ringing us, starting with Elizabeth City. Then we go to Roanoke Rapids, Rocky Mountain, by the way, which is owned by an interest in a foreign country, Kinston, Jacksonville, Goldsboro, Newland. The four of us never miss a week but what we receive a call, a visit, or a letter wanting to negotiate for the sale of our paper from some chain."

Now, Mr. Chairman, the papers, as Mr. Levin can point out, some of these chains are offering tremendous amounts of money, something like 40 to 50 times earnings, and because they are being offered this kind of money for their papers, of course, IRS has little alternative but to take that into consideration when they are valuing the value of a paper for estate tax purposes, which makes it almost impossible for a family, once a person has died, the owner has died, to retain the paper. So many of them all over the country are selling out.

One other thing I might mention, since this list was prepared, I know that the Burlington Times News, which is listed here as a locally owned paper, has been acquired by an out-of-State chain. Now, the Highpoint Enterprise paper was sold. I am not sure if it went with a chain or not. Freedom Newspapers own about five papers in our State. The New York Times owns three. Multimedia owns the Asheville Citizen. Media Central owns Winston-Salem, which also owns the Norfolk paper, which covers all of northeastern North Carolina, and so on.

Now, what is our remedy? I heard about a proposal that had been offered in the House by Congressman Udall. I make no claim that this is an original idea with me. I do make the claim that I have been concerned with it for almost 10 years, since the time I went in as attorney general, but I heard about Morris Udall's bill and I began to look at it. Now, these gentlemen I did not even know at the time. Mr. Levin did not come to see me. I went to see Mr. Levin, and I think I met Mr. Siegenthaller with Howard Baker one time in the Senate restaurant, but other than that I never had any dealing or correspondence with him. What I am saying is, the introduction of this bill in the Senate was my idea. I have no interest in any newspaper, but I do have an interest in the free press.

This bill takes two approaches. First, it would allow an independent paper, and that is defined in our bill as one which operates wholly within a State, and there are some other restrictions which Mr. Levin may talk about, to put away up to 50 percent of its gross earnings into a trust fund which would be invested in Government securities. Now, that would be deductible as a business expense, and the trust would be used to pay the estate taxes after the death of the owners. It would not be taxable as a part of the estate.

The second approach simply would permit the heirs to delay the payment of the taxes, of course, with payment of interest. According to the Joint Committee on Taxation, and I have a letter which I submit for the record, this would reduce Federal budget receipts by about $10 million a year. Now, that is a small amount, I think, to pay, Mr. Chairman, for the preservation of some independent newspapers. It will not save all of them.

Senator PACKWOOD. Let me ask you this. You and I come down on exactly the same side. It is a small amount if we could save the independent newspapers. What guarantees do we have that the heirs will come to run the newspapers?

Senator MORGAN. We have no guarantees, but we have made some surveys, and Mr. Levin, who represents the Independent Local Newspaper Association, has some ideas, and with your permission I would yield to him.

Senator PACKWOOD. Yes.

Mr. LEVIN. I think the bill lacks a recapture clause as the 1976 act has a recapture clause, and we would have absolutely no objection to like language going in. There should be, I guess, to keep it even and balanced, some sort of recapture, and I am sure you were going to talk about 10 years of recovery.

Senator PACKWOOD. On the estate taxes, and basically small businesses and farms.

Mr. LEVIN. Yes.

Senator PACKWOOD. Excuse me, Bob. I did not mean to interrupt.

Senator MORGAN. I had about covered it. Let me read another paragraph from my friend Ashley's letter. He says, "I do care about my community, but the offers can be unbelievable. My son, Ashley, Jr., graduates next week, and all his life the only course he has wished to pursue is to takeover the newspaper. He comes in with me upon graduation, and of course the greatest challenge in my life is to have the paper as ready for him and him as ready for the paper as I can. I cannot say how he will manage to pay estate taxes as some others have had to do. It is possible that unless some relief comes he would have to sell it in order to pay estate taxes. I hope not. We have taken out insurance, and over the years I have been giving stock as fast as possible. I hope for the best. Mr. Udall's bill is certainly a step in the right direction. Some would say that in a given community the same company should not own," and he goes on with the morning and evening papers. "There are some who say, why not do it by taking out insurance? But insurance is not always available."

I would like to ask Mr. Levin and Mr. Siegenthaller if they would speak on this.

Mr. LEVIN. I am going to ask Mr. Siegenthaller to start. He is a publisher, and he has a specific interest here.

Mr. SIEGENTHALLER. Mr. Chairman, I appreciate, first of all the opportunity to be here with the Senator, and I appreciate his interest, which, as he said, was volunteered. I am president of the Independent Local Newspaper Association, and as such I am not a newspaper owner. The owner of the Tennesseean is the Evans family, and I am publisher of the paper. They, I think, understand and appreciate the impact of chain purchases on our industry.

There are now, as the Senator says, about 600, and they are going at a rate of about 60 a year, which gives us about a 10-year supply of local newspapers. Of course, as owners become more advanced in age, their interest in protecting their heirs is very real. There are two stockholders on the Tennesseean, Ame Carter Evans and his mother. She is now advanced in years, and I think should she die the tax owner estate would be in the neighborhood of 70 percent.

The paper has been profitable, and most papers are. The industry is healthy, but the prospect of having to borrow vast sums of money to pay estate taxes over a period of extended years when compared with the prospect of selling a chain at a phenomenal rate is really not much of an option for many people, and I think that really tells why the acceleration has taken place and why so many papers are going so fast.

Mr. LEVIN. Just briefly, Mr. Chairman, in the last 10 to 12 years that I have represented newspapers, I have lost a number of publish-

ers because they have gone on to be bought out by chains. The prices they are paying today for newspapers has reached 50 to 60 times earnings. If a newspaper were, for example making $1 million a year and someone was willing to pay $50 million for it, let's just use the quick 70 percent estate tax rate, that paper has got to be worth estate taxwise maybe $30 million to the Government, or $35 million. You cannnot borrow money if you have only got $1 million to pay it back with.

It is a problem. I heard Mr. Halperin say over on the House side that this should be an antitrust problem.

Senator Packwood. Why are they worth so much to the chains? How on earth do they make any money out of it, paying that kind of price?

Mr. Levin. There are two ways. I am not condemning chains, because as Senator Morgan's statement points out, there are good chains and bad chains. They do cut costs by using a wire service, particularly your own service. You do not need reporters. You cut costs up and down the line. That is a good way of saving.

Senator Packwood. Don't most of the local papers use AP and UPI now, or the New York Times Service, or some others?

Mr. Levin. Yes, not as a replacement, but as a supplement to their own staff and reporters.

Senator Packwood. Most local papers, even when taken over by chains, still keep local reporters for purposes of local news.

Mr. Levin. It gets cut back. I have been at meetings where former clients were told that you did not need so many reporters, in one case it happened to be a lady who was the editor of the women's page. She was told she was taking over theater as well, because they saw no reason to keep two people on, one for women's news and the other for theater.

Senator Packwood. But that is consolidation. There is no earthly wire service that is going to cover your local theater and society page.

Mr. Levin. That is correct.

Senator Packwood. So in that instance they are not doing anything that a local owner could not do.

Mr. Levin. A local owner, depending upon his pride in his project, and depending upon how much money he wants to make, could do anything a chain is doing.

Senator Packwood. I just do not understand how a chain could pay 50 or 60 part-time earnings and come out.

Mr. Levin. That is the second part. They are playing in inflated dollars and they figure by the time they get done paying off it will not cost them as much. I cannot speak for the chains. I am speculating with you, but I can tell you that because there are so few independents left they are paying these prices and they are bidding each other up, and I was in a bidding situation a little under 2 years ago where I was representing a person who wanted to buy a newspaper himself, and I told him that he could afford to go 25 to 30 times earnings, and the price went over 55 times earnings.

I called the Justice Department Antitrust Division. I am well acquainted with the the attorneys there, and they said there was no way they could touch it, absolutely no way under the antitrust laws.

Senator PACKWOOD. I know what you mean. Except for two small intrastate chains in Oregon, most of our dailies have gone the route of the interstate chains now.

Mr. LEVIN. The intrastate chains—and I can guess which ones you are talking about—would be covered.

Senator PACKWOOD. Yes, I saw that, and by and large when you are talking about intrastate, you are talking about six or seven papers. They may be weeklies. A couple of them may be smaller dailys.

Mr. LEVIN. That is the type of thing we have. I cannot explain to you the economics of how—can buy combined communications. I do not understand it, so I am just speculating.

Senator PACKWOOD. Anything more, Bob?

Senator MORGAN. Only this. I submitted the article from U.S. News & World Report when I introduced the bill. I remembered having read an early article recently in Esquire, I believe. Last night, coming back on the plane, I just happened to pick up an August issue of Esquire, and it had this article, "The Press' Great Threat," and it is only about a page and a quarter. I would like to submit this for the record, and also hand you one personally, because it is a fascinating article, and it expresses far better than I could the dangers I see in this.

Senator PACKWOOD. It will be put in. We thank you for introducing the bill. It is a problem that is enedmic in every State, and I hope we can solve it.

[The material referred to follows:]

THE PRESS'S GREAT THREAT—IT'S NOT THE SUPREME COURT'S DECISION, BUT THE NEW OWNERS THEMSELVES

(By Richard Reeves) [1]

In May, when the Gannett Company bought out Combined Communications Corporation for $370 million—adding two newspapers, seven television stations, and thirteen radio stations to Gannett's seventy-seven newspapers—*Newsweek* commemorated the event by publishing a photograph of Gannett's president, Allen Neuharth, in his shirt sleeves in the city room of *The Rochester Times Union*. That caused quite a laugh at the *Times-Union* because, as one reporter told me, it was the first time anybody had seen Neuharth in the newsroom for ten years.

The story reminded me of one of the reasons I left The New York *Times*. When I got to the *Times* in 1966, reporters were called "Mister"—except for the few who were called "Mrs." or "Miss." When you screwed up your expense account, a woman from the accounting department would call and say: "Mr. Reeves, I'm sorry to bother you, but if you have some time. . . ." By 1971, the same woman, who was quite nice about it all, would summon you to her office and inform you that if you did not clear up your account forthwith, you would receive no more out-of-town assignments.

The accountants had taken over and, according to The *Times's* annual report, business is better for it. According to Gannett's latest annual report:

"Dear Gannett Shareholder:

"Here is a headline summary of Gannett's first ten public years:

"Growth in annual revenues, from $185 million to $558 million. . . . Growth in earnings per share, from 58 cents to $2.60. . . . Growth in dividends, from 22 cents per share to $1.20.

"We pledge that the Gannett family of 16,000 employees will remain dedicated to deliver for you certain successes, no matter how uncertain the times."

[1] Richard Reeves is the national editor of Esquire magazine.

Neuharth signed that message, in case any reporter at the *Times-Union* or the other seventy-six Gannett papers should misunderstood their real function and be tempted to babble on about the news or readers.

The numbers change from day to day, but right now approximately 75 percent of the newspaper circulation in the United States is controlled by 167 chains like Gannett; 25 percent of that circulation is controlled by the four largest chains, in order: Knight-Ridder Newspapers Inc., Newhouse Newspapers, (Chicago) Triune Company, and Gannett. The reason the numbers change is that the chains are buying up independent papers faster than I can type. "You go into a hotel in any small town," said Donald Barhyte, financial vice-president of Multimedia Inc., which owns nine papers, "and you keep running into the same people from [Los Angeles] Times Mirror, Newhouse, Gannett, and all the other chains."

Granting that some chain newspapers are quite good (The *Miami Herald*) and that some independent papers are horrible (*The Manchester Union-Leader*), the future is as visible as McDonald's Golden Arches. Gannett and McDonald's are in the same business—and that business is not causing trouble, or, as they must have once said in Rochester newsrooms, "raising hell." A few months ago, Gannett announced a round of changes in publishers of their papers: they sent one from Bridgewater, New Jersey, to Honolulu; another from Niagara, New York, to Bridgewater; another from Rockland County, New York, to Fort Myers, Florida; another from Fort Myers to Springfield, Missouri. Now you can find out that these switches guarantee an independent press by sending to Gannett for a free copy of "Newspapers: Your Freedom Wrapper." But that is fish-wrapping.

What Gannett is doing is training a cadre of competent managers with one charge: maintain the corporation's dazzling growth rate. They can do that only by cutting costs in strange new towns and increasing advertising—which means kissing the asses of the local establishment. The cranky publishers of yore—many incompetent, some dishonest, all being wiped out because families have to sell out to pay inheritance taxes—were at least part of the local establishment and could use their power to negotiate. A Gannett publisher can't—if he loses department store advertising because of some lunatic reporter and revenues drop for even a few months, he's on his way back to Bridgewater.

And Gannett is far from the worst. Thomson Newspapers, with sixty-three dailies and six weeklies (in the U.S.) totaling just over one million in circulation, maintains a bureau in Washington where reporters send their stories in by mail to save transmission costs. And the smaller the newspaper conglomerates get, I found, the worse they seem to be. I found that by going back where I started, to Warren County, New Jersey.

Warren County is in the northwestern part of the state, sixty miles west of New York City. In 1961, I was the first editor of a weekly paper there, *The Free Press*, in Phillipsburg. We raised some hell and we did okay—largely because the dominant local daily paper, *The Express*, across the Delaware River in Easton, Pennsylvania, did a lousy job in Jersey. And other pretty good Warren County weeklies—*The Washington Star* and *Hackettstown Gazette*—covered their towns like the dew.

Today, dammit, *The Express* owns *The Free Press*, *The Star*, and *The Gazette* or what's left of them. The Jersey papers keep publishing, not much, but publishing, and the reason, it seems clear, is that they have to, because New Jersey law requires that legal advertising, the backbone of the weekly business, has to appear in papers published within the state.

The lusty little papers of my youth are jokes. But they are not as funny—or sad—as what *The Express* has replaced them with: a shopper called *The Forum*. *The Forum* is delivered free to more than 100,000 homes in northwest Jersey. It is a make-believe newspaper with no purpose other than making the advertising look respectable. The June 21 issue bannered such news as "European Wasp Could Be Solution to Bettle Problem" . . . "Helen Reddy Turns Philanthropist, Environmentalist" . . . "Social Security News" . . . "Community Calendar" . . . "People in Business" . . . "Maple Trees Face Onslaught of Several Deadly Diseases."

That seems to be where we're going. And that's why Gannett pays Allen Neuharth more than $400,000 a year—including the bonuses he gets for maximizing this year's profit—and why he doesn't feel he has to visit the newsroom more than once a decade.

Suffice it to say that a lot is being written to convince people that the greatest threat to freedom of the press in America is the Supreme Court's decision allowing law enforcement agencies to search newspaper files without a warrant. That is not true. The greatest threat to the press is the people who now own it—and their accountants. When the cops do break into most American newsrooms, they're not going to find much more than wedding announcements and PTA bulletins.

Senator PACKWOOD. Mr. Halperin, do you have any comments?

Mr. HALPERIN. Thank you, Senator Packwood.

We have been through three areas this morning where we have described a serious problem which we all agree ought be to solved if it possibly can. We have then jumped to a tax solution without any real effort in this case and the first case, unlike the second, to show why the tax law is a problem and how the proposed solution will help. It is too simple to say there is a difficulty, and if we just cut everybody's taxes the problem will go away. We have to try to connect it up. If the problem is liquidity, there are already provisions in the estate tax laws for helping people with liquidity problems. If they are inadequate, they should be reexamined to see whether there can be further changes for newspaper businesses as well as everybody else.

If the problem is overvaluation because the business is not worth as much to the independent owner as it would be to a chain purchaser and therefore ought to be valued at its internal value, perhaps that is something that could be dealt with. That was done with farms and closely held businesses in the 1976 act. Perhaps we could look to see whether that should be extended to other cases.

But this bill goes much further. This bill gives a tax deduction for amounts used to pay estate taxes. The amounts set aside are not income to the recipient, even when used to pay estate taxes. If a trust is created, it becomes tax exempt. The amount in the trust used to pay estate taxes is not subject to the estate tax itself. Those are extraordinary benefits. Nothing like that exists any place else in the tax law. There is no indication as to why we should do that in this case and how doing that will solve the problem.

A recapture provision at least takes back the tax benefits. However, it would be an awfully difficult thing to devise. It is not quite the same as just recapturing the estate tax benefit, which is done in the 1976 act with farms and closely held businesses.

I do not see how the case has been made that these proposals will solve the problem. Certainly, if you cut people's taxes and make it cheaper taxwise to own newspapers, there is a greater incentive to own newspapers. That is true of everything else, and it is not clear to me why this takes precedent over other businesses or other important concerns.

Senator PACKWOOD. I understand your position. Thank you very much.

Mr. LEVIN. Thank you.

Senator PACKWOOD. Next we will take Mr. K. Prescott Low.

Mr. Halperin, let me ask you a question if I might while Mr. Low is coming on. Going back to the self-insurance on the product liability, were you aware of any states and industrial accident laws which allow self-insureds? How do we treat the reserves when a company is self-insured for industrial accident purposes?

Mr. HALPERIN. I believe they are not deductible currently.

Senator PACKWOOD. Thank you. Mr. Low?

STATEMENT OF K. PRESCOTT LOW, PUBLISHER, THE PATRIOT LEADER, QUINCY, MASS., AND CHAIRMAN OF THE TAX LAW TASK FORCE OF THE AMERICAN NEWSPAPER PUBLISHERS ASSOCIATION, ACCOMPANIED BY W. TERRY MAGUIRE

Mr. Low. My name is Prescott Low. I am the publisher of the Patriot Ledger, a locally owned independent daily newspaper published in Quincy, Mass. I am also a member of the board of directors of the American Newspaper Publishers Association and the chairman of that association's tax law task force. It is in this latter capacity I appear before you this morning.

ANPA is a trade association whose more than 1,300 member newspapers comprise some 91 percent of the daily and Sunday newspaper circulation in the United States. Many nondaily newspapers are also members. With me today is W. Terry Maguire, general counsel for the National Newspaper Association. NNA is an organization of some 900 daily newspapers that serve smaller cities and some 5,500 weekly newspapers throughout the United States.

NNA and ANPA are working together to analyze S. 3441 and identical legislation in the House, H.R. 12395, introduced by Representative Udall.

Mr. Chairman, NNA has authorized me to say that my testimony this morning also represents NNA's general position toward this legislation. With your permission, Mr. Maguire will submit a short additional statement for the record.

On behalf of the NNA and the ANPA I thank the chairman and the members of this subcommittee for the opportunity to testify on S. 3441, the Independent Local Newspaper Act. As you know, Mr. Chairman, this legislation is aimed at helping to preserve independent local ownership of newspapers by addressing one of the reasons why such owners sell their newspapers to newspaper groups. That is the burdensome and some would say punitive Federal estate tax laws.

ANPA, whose membership includes both independently owned and group-owned newspapers, does not at this time endorse S. 3441 as the possible final vehicle for best accomplishing this end. Neither do we specifically oppose the bill. We do encourage the Congress to continue its analyses and deliberations. We are in the hope that prompt and proper solutions may be found, including ways to make the estate tax laws neutral on the question of succession of closely held ownership.

We very much appreciate the concern of the chief Senate sponsor of this legislation, Mr. Morgan. We commend him for following that concern with specific legislation to remove estate tax laws as one of the factors which in many cases inordinately influences decisions to sell newspapers. Further, we acknowledge that if this legislation were enacted in its present form, it would bring considerable relief to those independent newspaper owners who would qualifby under this bill.

However, ANPA is not yet convinced that the approach set forth in S. 3441 is the sole or best one to pursue, either for the country in general or for the newspaper business in particular.

Before mentioning some of the questions we have about this specific legislation, I think it is important that the subcommittee note that ANPA and NNA do not come here today as late starters in this matter. Indeed, it was many of our member publishers who pointed out to in-

terested Member of the Congress the deleterious role ofthe Federal estate taxes on newspaper ownership. More important, NNA and ANPA decided this situation warranted special attention by the newspaper business. The ANPA Board of Directors late last year established its tax law task force and directed it "to seek legislative changes, encouraging neutrality in the Federal estate tax laws so that newspaper publishers and other businessmen may make such ownership decisions as they deem appropriate without unnecessary or counterproductive legal strictures."

This task force, which I head, has met six times this year. Another meeting is schduled next month, and more are planned. The NNA has a similar group. Our initial efforts were to analyze this legislation. More recent meetings have focused on examination of the possible alternative approaches to provide tax relief.

In keeping with the subcommittee's request to be brief, I will list just some of the questions that our task force has expressed after analysis of S. 3441.

First and foremost is the unanswered question of whether legislation should provide relief for one class of citizens only, in this case newspaper owners, when estate taxes press equally hard on all small closely held businesses. In fact, the feeling that all affected businesses need relief has been the chief concern expressed by many of the publishers who have contacted me concerning this issue.

Other questions about this bill which our task force has identified include:

One: The relatively narrow coverage of the bill. Even though coverage has been expanded to include intrastate newspaper groups, S. 3441 still has the situation that the owner of two small newspapers in adjoining States—perhaps only a few miles apart—would be ineligible for relief.

Two: The vagueness of some of the definitions in the bill.

Three: The very severe penalty provisions in the event of inadvertent overfunding of the allowed trust fund.

The alternatives or supplemental actions which our task force is exploring include possible changes in the tax rate schedule, deductions, valuation, and timing of tax payments.

For example, under the valuation category, which Mr. Halperin also mentioned, a newspaper could be valued at its individual financial performance rather than under the present "comparable sale or merger price" basis. As you know, Mr. Chairman, a somewhat similar approach was appropriately adopted by the Congress in 1976 with regard to family-owned farms.

I hope it is clear from this short summary of ANPA and NNA's activity in this area that we do not profess to have any definitive answer to what should be done to best provide the Federal estate tax relief which is needed. We do want the subcommittee to know that the newspaper business is deeply concerned about this issue, and hard at work on it.

Our ANPA task force has as its goal presentation of a firm recommendation to the ANPA Board of Directors by the end of this year. The National Newspaper Association task force will meet again in

November at NNA's convention and will submit recommendations to NNA's Board of Directors shortly after that meeting. Thus, both associations are seeking early adoption of positions on this issue.

At this point, I have no idea what the final ANPA or NNA recommendation to the Congress will be. But, Mr. Chairman, we feel it is important here to note that any legislation dealing directly with the newspaper business should have, if possible, a consensus of support from this country's newspapers. That consensus does not yet exist for S. 3441 as the best or sole solution.

ANPA and NNA will continue their work. I sincerely hope that both associations can come before this subcommittee early next year and present definitive recommendations that reflect broad-based support from among our member newspapers.

Again, I thank you for the opportunity to inform you of our continuing activity on this important issue, and I would be happy to answer any questions you may have.

Senator PACKWOOD. Mr. Low, I do not have any questions. I think we all understand the situation very well. Your statement is very balanced and I appreciate it.

Mr. LOW. Thank you, sir.

Senator PACKWOOD. Thank you. Mr. Maguire, we will put your statement in the record along with the accompanying articles and editorials.

Mr. MAGUIRE. Thank you, Mr. Chairman.

[Prepared statements of the preceding panel follows:]

PREPARED STATEMENT OF SENATOR ROBERT MORGAN

Mr. Chairman, it is a pleasure to be here today to speak on the "Independent Local Newspaper Act of 1978."

First, let me express my thanks to the Chairman for the courtesy he extended to me in providing some time to testify before the Subcommittee on Taxation. I appreciate the time constraints under which the entire Finance Committee is operating.

Mr. Chairman, the bill which I introduced last week is a measure which I feel should be of the utmost interest to those of us in the Congress. Newpapers have become big business and as such the pattern of expansion, acquisition and concentration which has come to other business has now become a part of newspaper life. Every year there are fewer daily papers in operation and the number of independent papers, not controlled by a chain operation, is quickly diminishing.

At present, there are only some 650 independent local papers in operation. These papers vary in size and circulation. The chain operations now control some 72 percent of the daily news circulation in the United States and some 78 percent of Sunday publication.

On the average, in the last few years some 40 or 50 independent newspapers have been transferred into the hand of a chain operation. What this means is that there is one central publisher who can exercise his will to control the newspapers of several different cities. When the publisher of the New York Times has an editorial opinion favoring aid for the city of New York, he can try to get support from the little town of Lexington, N.C. because he knows that the Lexington Dispatch is owned by the New York Times.

Now, Mr. Chairman, I don't want to project some horror story or suggest some sinister motive on the part of chain newspaper operations. All I want to present to you is the reality that much of the control over the news we read in this country is passing out of the hands of community-based papers, into the control of centralized news operations.

I have a very real concern about this situation and I am sure that many other Senators share my interest in the preservation of an independent press in this

country. I want to stress independence as opposed to simply a free press, because I believe that a truly free press is very much tied to independence and some local control. Obviously, there can be abuse on the part of any type of news operation and for myself, I believe that a mix of chain and independent operations, which can provide alternative news sources and opinions, is best for the country.

After talking with several men in the newspaper business and expressing my concern over the increasing number of newspaper sales, I found that many newspapermen still consider the newspaper business a community service. With so much attention turned to the business side of the newspaper business, it was refreshing to find that many independent newsmen retain the feeling that theirs is a special occupation.

A large number of these independent newspaper operators did tell me that one reason that they are considering selling their papers, despite their desire to keep the paper in family or local hands, is the current estate tax laws on the books.

When an owner of a newspaper dies, his paper must be valued for estate tax purposes. Most owners argue that their real worth is about 10 to 15 times their annual income. But, with the big chains willing to pay 40, 50 and even 60 times the annual earnings, the Internal Revenue Service will set an estate value so high that it would be impossible to borrow enough money to pay the tax.

It is in anticipation of this fact that many newspaper operators consider selling their operations. They simply cannot hold on and face the heavy tax burden.

Congressman Udall has introduced in the House a companion bill to S. 3441 and hearings have been held on this measure. What we are trying to do is to provide an incentive to newspaper owners to hold on to their papers. It is an effort to assist them, it is not a cure-all for the problems they face.

Simply put this bill is in two parts. The first part allows newspapers the option of establishing a trust for the prepayment of estate taxes. There would be no reduction in the estate tax burden and the trust could only be used for that purpose. The trust is limited to local independent newspaper operations which have all their publication operations in one city or community. Additionally, in-state chains, which many will agree retain their local character, are covered by the bill if they were in existence before October 31, 1978.

The trust would be funded by U.S. obligations and an owner could contribute up to 50 percent of the newspaper's income to the trust. This contribution would be from pre-tax income and would be deductible from current income. In addition, the trust would not be considered a part of the owner's estate for tax purposes.

There are several benefits to this proposal which many may feel are very attractive. With this I agree. There must be some reason to divert 50 percent of income and I feel that this provision will be an incentive to use of the trust option.

The picture is not wholly one of benefits, however. The sale of a newspaper would result in severe penalty. Overfunding of a trust to avoid tax liability will incur penalties. In short, this bill has both some costs and some benefits and therefore should be seen as a balanced approach.

The second part of the bill would allow the heirs of an estate to extend the time for payment of the estate taxes where the trust did not provide sufficient money. As usual, interest would be charged on any unpaid balance.

Mr. Chairman, I don't want to go on with all the technicalities and specific provisions of this bill. I do want to note that the Joint Tax Committee has given us a revenue loss estimate on this bill and it is $10 million a year. I feel that for the benefits which we may secure from this measure, it is well worth this cost.

There are so many issues involved here. There is freedom of the press and there is the issue of tax benefits for a special group and I am sure many others.

What I would like to leave with the subcommittee is my very real concern that we do something about the increasing concentration in the newspaper business. Allowing a trust to be established to prepay estate taxes is a sound and reasonable approach to me.

The newspaper enterprise has been singled out by our Constitution for special attention and I believe it to be fitting that the Congress take up this issue at this time. I am afraid that if we wait too much longer we will find very few community papers left to assist.

Again, my thanks to the subcommittee and to the Chairman. Following my remarks, I would like to add for the subcommittee's consideration a memorandum on S. 3441 and a list of the daily newspapers that would be affected by this bill.

STATEMENT OF K. PRESCOTT LOW, PUBLISHER, THE PATRIOT LEDGER, QUINCY, MASS., AND CHAIRMAN OF THE TAX LAW TASK FORCE OF THE AMERICAN NEWSPAPER PUBLISHERS ASSOCIATION

Mr. Chairman: I am Prescott Low, publisher of The Patriot Ledger, a locally-owned, independent daily newspaper published in Quincy, Massachusetts. I also am a member of the Board of Directors of the American Newspaper Publishers Association and chairman of that Association's Tax Law Task Force. It is in this latter position that I appear before you today.

ANPA is a trade association whose more than 1300 member newspapers comprise some 91 percent of the daily and Sunday newspaper circulation in the United States. Many non-daily newspapers also are members.

With me this morning is W. Terry Maguire, general counsel of the National Newspaper Association. NNA is an organization of some 900 smaller-city daily and 5,500 weekly newspapers throughout the United States. NNA and ANPA are working together in analyzing S 3441 and identical legislation in the House, HR 12395, introduced by Representative Udall.

Mr. Chairman, NNA has authorized me to say that my testimony this morning also represents NNA's general position toward this legislation. With your permission Mr. Maguire will submit a short additional statement for the record.

On behalf of the ANPA and NNA membership, I thank the chairman and members of the subcommittee for this opportunity to testify on S 3441, the Independent Local Newspaper Act.

As you know, Mr. Chairman, this legislation is aimed at helping to preserve independent ownership of newspapers by addressing one of the reasons why such owners sell their newspapers to newspaper groups—that is, the burdensome, some would say punitive, federal tax laws.

ANPA, whose membership includes both independently-owned and group-owned newspapers, does *not* at this time endorse S 3441 as the possible final vehicle for best accomplishing this end. Neither do we specifically oppose the bill. We do encourage the Congress to continue its analyses and deliberations. We are in the hope that prompt and proper solutions may be found, including ways to make the estate tax laws neutral on the question of the succession of closely-held ownership.

We very much appreciate the concern of the chief Senate sponsor of this legislation, Mr. Morgan. We commend him for following up that concern with specific legislation to remove federal estate taxes as one of the factors which, in many cases, inordinately influence decisions to sell newspapers.

Further, we acknowledge that if this legislation were enacted in its present form, it would bring considerable relief to those independent newspaper owners who would qualify under the bill.

However, ANPA is not yet convinced that the approach set forth in S 3441 is the sole or best one to pursue—either for the country in general or the newspaper business in particular.

Before mentioning some of the questions we have about this specific legislation, I think it is important that the subcommittee know ANPA and NNA do not come here today as late starters in this matter.

Indeed, it was many of our member publishers who pointed out to interested members of Congress the deleterious role of federal estate taxes on newspaper ownership.

More important, ANPA and NNA decided this situation warranted special attention by the newspaper business.

The ANPA Board of Directors late last year established its Tax Law Task Force and directed it "to seek legislative changes encouraging neutrality in federal estate tax laws so that newspaper publishers and other businessmen may make such ownership decisions as they deem appropriate without unnecessary and counterproductive legal strictures."

This Task Force, which I head, has met six times this year; another meeting is scheduled next month, and more are planned. NNA has a similar group. Our initial efforts were to analyze this legislation. Recent meetings have focused on examination of possible alternative approaches to provide tax relief.

In keeping with the subcommittee's request to be brief, I will just list some of the questions our Task Force has expressed after analysis of S. 3441.

First and foremost is the unanswered question of whether legislation should provide relief for one class of citizens only—newspaper owners—when estate taxes press equally hard on all small, closely-held businesses. In fact, the feeling

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that all affected businesses need relief has been the chief concern expressed by the many publishers who have contacted me concerning this issue.

Other questions about this bill which our Task Force has identified include:

1. The relatively narrow coverage of the bill. Even though coverage has been expanded to include intra-state newspaper groups, S. 3441 still has the situation that the owner of two small newspapers in adjoining states—perhaps only a few miles apart—would be ineligible for relief.

2. The vagueness of some of the definitions in the bill.

3. The very severe penalty provisions in the event of inadvertent over-funding of the allowed trust fund.

The *alternatives or supplemental actions* which our Task Force is exploring include possible changes in the tax-rate schedule, deductions, valuation and timing of tax payments. For example, under the valuation category, a newspaper could be valued on its individual financial performance rather than under the present "comparable sale or merger price" basis. As you know, Mr. Chairman, a somewhat similar approach was appropriately adopted by Congress in 1976 for family farms.

I hope it is clear from this short summary of ANPA's activity in this area that we do not now profess to have any definitive answer to what should be done to best provide the federal estate tax relief which is needed.

We do want the subcommittee to know that the newspaper business is deeply concerned about the issue and hard at work on it. Our ANPA Task Force has as its goal presentation of a firm recommendation to the ANPA Board of Directors by the end of this year.

The National Newspaper Association's task force will meet again in November at NNA's Convention and will submit recommendations to the NNA Board of Directors soon after that meeting.

Thus, both associations are seeking early adoption of positions on this issue. At this point, I have no idea what the final ANPA recommendation to the Congress will be.

But, Mr. Chairman, the important point is that any legislation dealing directly with the newspaper business should have, if possible, a consensus of support from this country's newspapers. That consensus does not yet exist for S 3441 as the best or sole solution.

ANPA and NNA will continue their work. I sincerely hope that both associations can come before this subcommittee early next year and present definitive recommendations that reflect broad support from among our member newspapers.

Again, I thank you for this opportunity to inform you of our continuing activity on this important issue.

I will be happy to respond to any questions you may have.

Independent (non-chain) newspapers in the United States as of January 1, 1978

	Circulation
Alabama: Decatur: Daily	21,800
Alaska:	
Anchorage:	
News	15,300
Times	45,400
Fairbanks: News-Miner	17,000
Ketchikan: News	3,600
Kodiak: Mirror	1,600
Sitka: Sentinel	1,900
Arizona:	
Casa Granda: Dispatch	5,000
Nogales: Herald	2,700
Scottsdale: Progress	15,800
Tempe: News	15,900
Arkansas:	
Batesville: Guard	7,500
Benton: Courier	8,800
Blytheville: Courier News	10,200
Conway: Log Cabin Democrat	71,000
Forrest City: Times-Herald	4,100

Independent (non-chain) newspapers in the United States as of January 1, 1978—Continued

	Circulation
Arkansas—Continued	
Harrison: Times	7,700
Helena-West Helena: World	7,900
Jacksonville: News	8,900
Jonesboro: Sun	17,200
Little Rock: Arkansas Gazette	121,500
Newport: Independent	3,600
Paragould: Press	7,000
California:	
Alameda: Times Star	8,370
Bakersfield: Californian	58,000
Barstow: Desert Dispatch	7,600
Chico: Enterprise-Record	23,200
Colusa: Sun-Herald	3,300
Corning: Observer	1,900
Downey: Southeast News & Downey Champion	12,400
Fresno: Guide	21,300
Hemet: News	8,200
Hollister: Free Lance	4,400
Huntington Park-South Gate-Bell-Maywood: Signal	16,400
Lodi: News-Sentinel	12,300
Lompoc: Record	8,300
Martinez: News-Gazette	8,100
Orange County: Orange Coast Pilot	46,300
Oroville: Mercury-Register	9,200
Paso Robles: Press	3,200
Redlands: Daily Facts	7,700
Riverside:	
Enterprise	54,100
Press	31,900
Roseville: Press-Tribune	6,700
San Mateo: Times & News Leader	43,900
San Rafael: Independent-Journal	45,400
Santa Barbara: News-Press	45,400
Santa Cruz: Sentinel	23,300
Santa Monica: Outlook	34,500
Sonora: Union Democrat	6,700
South Bay: South Bay Breeze	76,300
Visalia: Times-Delta	17,700
Whittier: News	21,500
Woodland: Democrat	11,600
Yreka: Siskiyou News	4,800
Colorado:	
Canon City: Record	6,600
Craig: Northwest Colorado Press	2,000
Denver: Post	250,900
Durango: Herald	6,800
Grand Junction: Sentinel	22,000
La Junta: Tribune-Democrat	3,500
Lamar: Tri-State News	3,100
Leadville: Herald Democrat	2,000
Longmont: Times-Call	13,500
Loveland: Reporter-Herald	10,900
Montrose: Press	4,900
Pueblo: Chieftain	35,900
Rocky Ford: Gazette	2,900
Salida: Mountain Mail	2,200
Connecticut:	
Bridgeport:	
Telegram	13,000
Post	77,000
Bristol: Press	19,000
Hartford: Courant	247,000
Manchester: Journal Inquirer	20,000
Meriden-Wallingford: Morning Record and Journal	23,000

Independent (non-chain) newspapers in the United States as of January 1, 1978—Continued

	Circulation
Connecticut—Continued	
Middleton: Press	21,000
Naugatuck: News	5,000
New Britain: Herald	32,000
New Haven:	
Journal Courier	31,000
Register	100,000
New London: Day	38,000
Norwalk: Hour	21,000
Waterbury:	
Republican	33,000
American	38,000
Willimantic: Chronicle	10,000
Delaware: Dover: Delaware State News	24,200
Florida:	
Daytona:	
Journal	43,000
News	29,500
Lake Wales: Highlander	4,200
Diario Las Americans (Miami)	------
St. Petersburg:	
Times	191,400
Independent	34,900
Sarasota:	
Herald-Tribune	[1] 69,700
Journal	7,800
Winter Haven: News-Chief	14,900
Georgia:	
Albany: Herald	33,700
Americus: Times-Recorder	6,500
Augusta:	
Chronicle	51,900
Herald	19,270
Brunswick: News	12,300
Dublin: Courier-Herald Dispatch & Press	8,900
Gainesville: Times	18,700
Griffin: News	11,600
Jonesboro: News/Daily	8,200
Lawrenceville: Gwinnett News	12,800
Moultrie: Observer	7,700
Rome: News-Tribune	18,100
Thomasville: Times-Enterprise	10,200
Waycross: Journal-Herald	10,900
Hawaii:	
Honolulu:	
Advertiser	75,300
Hawaii Hochi	9,600
Hawaii Times	12,700
Idaho:	
Blackfoot: News	5,900
Idaho Falls: Post Register	19,900
Kellogg: News	6,200
Lewiston: Tribune	25,100
Moscow: Idahonian	5,600
Sandpoint: Bee	3,200
Wallace: North Idaho Press	2,600
Illinois:	
Alton, East Alton, Wood River: Telegraph	37,500
Beardstown: Illinoian-Star	2,600
Belvidere: Republican	5,700
Benton: News	6,600
Bloomington Normal: Pantagraph	51,600
Carmi: Times	4,100
Casey: Reporter	2,800

[1] Sunday.

Independent (non-chain) newspapers in the United States as of January 1, 1978—Continued

	Circulation
Illinois—Continued	
Champaign-Urbana: News-Gazette	40,400
Chicago: Defender	22,200
Chicago: Sun-Times	566,100
Clinton: Journal-Public	4,000
Du Quoin-Pinckneyville: Call	5,400
Eldorado: Journal	3,500
Galesburg: Register-Mail	22,100
Harrisburg: Register	7,600
Hoopeston: Chronicle-Herald	2,500
Jacksonville:	
Journal	8,500
Courier	8,744
LaSalle-Peru-Oglesby-Spring Valley: News-Tribune	20,200
Litchfield: News-Herald	5,300
Macomb: Journal	11,900
Marion: Republican	5,500
Mount Carmel: Republican-Register	4,500
Olney: Mail	7,700
Paris: Beacon-News	7,300
Paxton: Record	1,300
Peoria: Journal-Star	105,100
Pontiac: Leader	8,200
Quincy: Herald-Whig	31,100
Shelbyville: Union	4,700
Sterling-Rock Falls: Gazette	14,400
Streator: Times-Press	11,900
Taylorville: Breeze-Courier	9,600
Waukegan-North Chicago: News-Sun	40,700
West Frankfort: American	4,300
Indiana:	
Anderson:	
Herald	19,800
Bulletin	17,700
Berne: Witness/Adams County Sun	3,200
Bicknell: Knox County News	2,200
Bluffton: News-Banner	5,200
Chesterton: Tribune	3,500
Clinton: Clintonian	5,100
Columbia City: Commercial Mail	5,500
Connersville: News-Examiner	8,100
Decatur: Democrat	5,400
Elkhart: Truth	30,400
Evansville: Courier	63,900
Fort Wayne: Journal-Gazette	61,200
Fort Wayne: News-Sentinel	72,900
Goshen: News	13,000
Greencastle: Banner-Graphic	5,600
Huntington: Herald-Press	9,300
Jasper: Herald	9,900
Jeffersonville: News	16,400
Kokomo: Tribune	30,000
Lebanon: Reporter	6,800
Madison: Courier	9,300
Martinsville: Reporter	6,600
Monticello: Herald-Journal	5,500
Mt. Vernon: Democrat	3,900
New Castle: Courier-Times	13,600
Noblesville: Ledger	8,200
Portland: Commercial Review	6,200
Princeton: Clarion	6,500
Rensselaer: Republican	3,800
Rochester: Sentinel	4,700
Shelbyville: News	10,700
Spencer: World	3,400

Independent (non-chain) newspapers in the United States as of January 1, 1978—Continued

	Circulation
Indiana—Continued	
Sullivan: Times	5,100
Terre Haute:	24,300
Star	24,300
Tribune	47,500
Valparaiso: Vidette-Messenger	12,200
Warsaw: Times-Union	12,500
Winchester, Union City: News-Gazette	5,300
Iowa:	
Ames: Tribune	9,400
Atlantic: News-Telegraph	7,600
Carroll: Times Herald	6,000
Cedar Rapids-Marion: Gazette	67,500
Centerville: Iowegian & Citizen	5,700
Cherokee: Times	4,900
Clinton: Herald	23,000
Dubuque, East Dubuque: Telegraph-Herald	39,700
Fairfield: Ledger	5,500
Fort Madison: Democrat	7,700
Keokuk: Gate City	7,800
La Mars: Sentinel	5,500
Marshalltown: Times-Republican	16,200
Oelwein: Register	7,000
Perry: Chief	3,800
Washington: Journal	5,400
Kansas:	
Atchison: Globe	7,100
Augusta: Gazette	2,700
Beloit: Call	2,800
Burlington: Republican	2,500
Clay Center: Dispatch	3,800
Columbus: Advocate	3,400
Concordia: Blade-Empire	4,000
Council Grove: Republican	3,000
Dodge City: Globe	8,900
El Dorado: Times	5,900
Emporia: Gazette	11,500
Fort Scott: Tribune	6,100
Fredonia: Herald	2,400
Goodland: News	3,000
Independence: Reporter	7,900
Iola: Register	5,100
Junction City: Union	8,200
Larned: Tiller & Toiler	3,200
Lawrence: Journal-World	18,200
Lyons: News	3,400
McPherson: Sentinel	5,800
Neodesha: Sun	1,200
Norton: Telegram	3,800
Parsons: Sun	9,200
Wellington: News	4,500
Kentucky:	
Ashland: Independent	25,500
Bowling Green, Park City News	17,000
Corbin: Times-Tribune	8,000
Fulton Leader	3,600
Hopkinsville: Kentucky New Era	14,700
Louisville:	
Courier-Journal	208,200
Times	161,700
Murray: Ledger & Times	7,400
Owenboro: Messenger & Inquirer	31,400
Paducah: Sun-Democrat	29,800
Somerset: Commonwealth Journal	10,500
Winchester: Sun	6,100

Independent (non-chain) newspapers in the United States as of January 1, 1978—Continued

	Circulation
Louisiana:	
Alexandria-Pineville: Town Talk	34,800
Bastrop: Enterprise	6,200
Baton Rouge:	
Advocate	67,130
State Times	46,000
Shreveport: Journal	40,100
Maine:	
Bangor: News	78,000
Biddeford-Saco: Journal	10,000
Lewiston-Auburn:	
Sun	33,000
Journal	14,000
Maryland:	
Baltimore: Sun	176,300
Cumberland:	
News	13,800
Times	20,500
Easton: Star-Democrat	6,900
Frederick:	
Post	17,400
News	12,800
Massachusetts:	
Athol: News	5,300
Boston: Christian Science Monitor	165,000
Brockton: Enterprise & Times	56,000
Chelsea: Record	4,000
Clinton: Item	4,000
Lawrence: Eagle-Tribune	49,000
Gardner: News	8,000
Lowell: Sun	54,000
Lynn: Item	30,000
Milford: News	13,500
Northhampton: Hampshire Gazette	17,000
Quincy: Patriot Ledger	73,000
Salem: News	30,000
Southbridge: News	6,000
Wakefield: Item	7,000
Waltham: News-Tribune	14,000
Woburn: Times	10,000
Michigan:	
Alpena: News	12,700
Benton Harbor, St. Joseph: Herald-Palladium	36,200
Cadillac: News	8,500
Cheboygan: Tribune	4,200
Coldwater: Reporter	8,600
Greenville: News-Banner	8,000
Houghton: Mining Gazette	11,800
Ionia: Sentinel-Standard	4,400
Ludington: News	8,800
Menominee: Herald-Leader	4,800
Monroe: News	25,200
Owosso: Argus-Press	15,000
Petoskey: News-Review	10,100
Royal Oak: Tribune	52,600
Sault Ste. Marie: News	8,900
South Haven: Tribune	3,800
Three Rivers: Commercial	4,700
Minnesota:	
Brainerd: Dispatch	13,700
Faribault: News	8,600
Fergus Falls: Journal	13,700
Moorhead: Forum	19,200
Stillwater: Gazette	4,900
Waseca: Journal	4,900

Independent (non-chain) newspapers in the United States as of January 1, 1978—Continued

	Circulation
Minnesota—Continued	
Willmar: West Central Tribune	18,800
Winona: News	19,000
Worthington: Globe	17,400
Mississippi:	
Biloxi-Gulfport:	
South Mississippi Sun	10,400
Herald	32,800
Brookhaven: Leader	6,000
Clarksdale: Press Register	7,300
Columbus: Commercial Dispatch	12,900
Greenville: Delta Democrat-Times	17,400
Grenada: Sentinel Star	4,800
Meridian: Star	23,800
Oxford: Eagle	4,000
Tupelo: Journal	34,200
Vicksburg: Post	15,800
Missouri:	
Aurora: Advertiser	3,800
Brookfield: News-Bulletin	5,400
Carrollton: Democrat	2,900
Clinton: Democrat	3,700
Columbia: Missourian	7,600
Crystal City-Festus: News-Democrat	7,400
Farmington: Press	3,200
Fulton: Sun-Gazette	4,900
Jefferson City:	
Capital News	5,300
Post-Tribune	15,380
Kansas City:	
Times	325,200
Star	300,300
Kennett: Democrat	5,500
Kirksville: Express & News	9,100
Lamar: Democrat	3,300
Lebanon: Record	5,100
Lexington: Advertiser-News	
Mexico: Ledger	12,300
Neosho: News	6,600
Poplar Bluff: American Republic	15,500
Richmond: News	3,000
St. Joseph:	
Gazette	44,700
News-Press	41,100
Sikeston: Standard	11,100
Trenton: Republican-Times	4,700
Warrensburg: Star-Journal	5,500
West Plains: Quill	8,700
Montana:	
Livingston: Enterprise	3,500
Miles City: Star	4,200
Nebraska:	
Falls City: Journal	5,500
Holdrege: Citizen	3,900
Kearney: Hub	10,100
McCook: Gazette	10,400
Norfolk: News	20,900
Omaha: World-Herald	124,100
Nevada:	
Elko: Free Press	3,200
Fallon: Eagle Standard	2,400
Las Vegas: Sun	39,000
North Las Vegas: Valley Times	7,600
New Hampshire:	
Dover: Foster's Democrat	19,000
Laconia: Citizen	7,000
Nashua: Telegraph	24,000

Independent (non-chain) newspapers in the United States as of January 1, 1978—Continued

	Circulation
New Jersey:	
Asbury Park: Press	92,900
Atlantic City: Press	69,700
Bergen County: Record	150,900
Bridgeton: News	11,600
Morristown, Parsippany:	
Daily Record	47,800
Parsippany's Daily Record	6,686
New Brunswick: Home News	56,800
Newton: New Jersey Herald	15,800
Perth Amboy-Woodbridge: News Tribune	52,400
Red Bank-Middletown-Shrewsbury: Register	84,100
Salem: Today's Sunbeam	10,900
New Mexico:	
Alamogordo: News	8,700
Albuquerque: Journal	75,800
Artesia: Press	2,800
Farmington: Times	12,200
Gallup: Independent	9,500
Grants-Milan: Beacon	3,800
Las Vegas: Optic	3,400
Los Alamos: Monitor	4,400
Lovington: Leader	2,900
Portales: News-Tribune	3,900
Roswell: Record	12,600
Raton: Range	3,100
Silver City: Press & Independent	6,400
Tucumcari: News	2,200
New York:	
Amsterdam: Record & Democrat	14,300
Batavia: News	13,400
Buffalo: Courier-Express	124,100
Canadaigua: Messenger	8,800
Cortland: Standard	12,900
Dunkirk-Fredonia: Observer	13,800
Geneva: Times	17,900
Gloversville-Johnstown: Leader-Herald	14,700
Hicksville-Bethpage: Centre Island News	5,100
Hudson: Register-Star	13,200
Little Falls: Times	6,500
Malone: Telegram	6,000
Medina: Journal-Register	5,400
Brooklyn: Challenge	92,000
New York: World	82,400
Olean: Times-Herald	25,400
Rome: Sentinel	19,100
Salamanca: Republican-Press	4,100
Saranac Lake: Adirondack Enterprise	4,800
Schnectady: Gazette	64,100
Watertown: Times	41,700
North Carolina:	
Asheboro: Courier Tribune	18,000
Chapel Hill: Newspaper	5,500
Concord: Tribune	11,600
Dunn: Dispatch	4,400
Dunn: Record	5,700
Durham:	
Herald	40,600
Sun	21,700
Fayetteville:	
Times	18,000
Observer	43,000
Granville: Reflector	18,500
Hickory: Record	26,000
Lumberton: Robesonian	12,600
Monroe: Enquirer-Journal	9,000
Morgantown: News-Herald	10,000

Independent (non-chain) newspapers in the United States as of January 1, 1978—Continued

	Circulation
North Carolina—Continued	
Newton: Observer	4,000
Rockingham: Richmond County Journal	6,800
Salisbury-Spencer-East Spencer: Post	23,000
Sanford: Herald	12,000
Shelby: Star	16,000
Statesville: Record & Landmark	16,500
Tarboro: Southerner	5,000
Tryon-Bulletin	3,000
Washington-News	9,000
Wilson-Times	17,000
North Dakota:	
Bismarck-Tribune	27,600
Devil's-Lake Journal	5,500
Fargo: Moorhead Forum	59,200
Jamestown: Sun	9,800
Minot: News	31,900
Ohio:	
Athens: Messenger	14,300
Bellefontaine: Examiner	10,300
Bellevue: Gazette	4,200
Bowling Green: Sentinel-Tribune	13,000
Bryan: Times	9,200
Celina: Standard	10,100
Circleville: Herald	8,800
Columbus: Dispatch	194,500
Delaware: Gazette	8,600
Delphos: Herald	3,600
East Palestine: Leader	3,000
Fairborn: Herald	7,900
Findlay: Courier	25,100
Galion: Inquirer	6,500
Greenville: Advocate	9,400
Hillsboro: Press Gazette	4,600
Lisbon: Journal	8,100
Logan: News	6,300
Marysville: Journal-Tribune	5,800
Mount Vernon: News	11,200
Napoleon: Northwest-Signal	5,800
St. Mary's: Leader	6,700
Shelby: Globe	4,600
Sidney: News	12,300
Troy: News	10,900
Unrichsville-Dennison: Chronicle	4,600
Urbana: Citizen	7,700
Van Wert: Times-Bulletin	8,200
Wapakoneta: News	4,700
Warren: Tribune Chronicle	43,900
Washington Court House: Record-Herald	7,900
Wilmington: News-Journal	8,200
Youngstown: Vindicator	99,100
Oklahoma:	
Ada: News	9,400
Anadarko: News	5,100
Ardmore: Ardmoreite	12,300
Clinton: News	5,300
Duncan: Banner	10,700
Durant: Democrat	7,200
Elk City: News	4,400
El Reno: Tribune	4,800
Enid:	
News	19,700
Eagle	10,100
Hobart: Democrat Chief	3,100
Hugo: New	3,200

Independent (non-chain) newspapers in the United States as of January 1, 1978—Continued

	Circulation
Oklahoma—Continued	
Idabel: McCurtain Gazette	5,000
Lawton:	
Press	14,200
Constitution	17,300
Norman: Transcript	14,200
Nowata Star	2,700
Oklahoma City: Oklahoma Journal	47,700
Perry: Journal	3,400
Ponca City: News	13,700
Sayre: Journal	2,500
Seminole: Producer	4,600
Stillwater: News-Press	8,900
Tulsa:	
World	116,100
Tribune	77,900
Vinita: Journal	3,700
Weatherford: News	3,100
Woodward: Press	5,200
Oregon:	
Astoria: Astorian	8,500
Grants Pass: Courier	14,400
Pendleton: East Oregonian	12,000
Portland: Journal of Commerce	4,200
Pennsylvania:	
Allentown:	
Call	100,200
Chronicle	21,600
Bangor: News	3,100
Bethlehem: Globe-Times	34,200
Bradford: Era	13,100
Brownsville: Telegraph	7,800
Butler: Eagle	29,500
Chambersburg: Public Opinion	19,400
Chester-Upper Darby: Delaware County Times	36,900
Columbia: News	4,700
Corry: Journal	4,500
Dubois: Courier-Express	11,500
Easton-Wilson & Phillipsburg, N.J.: Express	52,100
Ellwood City: Ledger	10,900
Franklin-Oil City: News-Herald	9,200
Gettysburg: Times	11,300
Greensburg: Tribune-Review	38,800
Hazleton: Standard-Speaker	23,700
Indiana: Gazette	19,800
Jeannette: News-Dispatch	10,800
Johnstown: Tribune-Democrat	59,460
Kane: Republican	3,000
Lancaster:	
Intelligencer Journal	39,100
New Era	58,000
Lansdale: North Penn Reporter	18,000
Latrobe: Bulletin	11,300
Lebanon: News	28,200
McKeesport-Duquesne-Clairton: News	36,700
Milton: Standard	4,800
New Castle: News	22,700
Norristown: Times-Herald	34,400
Oil City-Franklin: Derrick	16,200
Phoenixville: Phoenix	6,600
Pottsville: Republican	28,600
Punxsutawney: Spirit	6,300
Quakertown: Free Press	7,700

Independent (non-chain) newspapers in the United States as of January 1, 1978—Continued

	Circulation
Pennsylvania—Continued	
Reading:	
Times	40,200
Eagle	44,900
Ridgway: Record	3,800
St. Mary's: Press	4,900
Scranton: Tribune	36,900
Shamokin & Mount Carmel: News-Item	15,300
Somerset: American	7,800
State College: Center Times	18,700
Titusville: Herald	5,400
Tyrone: Herald	4,000
Vandergrift: News-Citizen	2,700
West Chester: Local News	31,600
Wilkes-Barre Times-Leader-News: Record	69,000
Willamsport: Sun-Gazette	34,800
York: Dispatch	48,200
Rhode Isand:	
Newport: News	15,000
Providence:	
Journal	67,000
Bulletin	142,000
Westerly: Sun	10,000
Pawtuxet Valley: Times	10,000
Woonsocket: Call	32,000
South Carolina:	
Charleston:	
News & Courier	63,600
Post	35,100
Florence: News	27,500
Greenwood: Index-Journal	15,100
Orangeburg: Times & Democrat	14,500
Sumter: Item	17,600
Union: Times	6,300
South Dakota:	
Belle Fourche: Post	3,300
Huron: Plainsman	13,800
Madison: Leader	4,000
Pierre Capital: Journal	4,300
Watertown: Public Opinion	17,400
Yankton: Press & Dakotan	9,400
Tennessee:	
Chattanooga: News-Free Press	62,600
Elizabethton: Star	5,700
Harriman: Today's News	5,100
Kingsport: Daily News	2,700
Knoxville: Journal	60,000
Maryville-Alcoa: Times	17,800
Morristown: Citizen Tribune	19,700
Nashville: Tennessean	127,500
Paris: Post-Intelligencer	8,000
Shelbyville: Times-Gazette	7,800
Union City: Messenger	8,600
Texas:	
Bonham: Favorite	4,500
Dalhart: Texan	2,600
Del Rio: News-Herald	6,400
Denton: Record-Chronicle	14,100
Edinburg: Review	3,700
Ennis: News	4,000
Gonzales: Inquirer	2,200
Houston: Chronicle	308,100
Houston: Post	299,200
Kerrville: Times	5,300
Kilgore: News Herald	6,000

Independent (non-chain) newspapers in the United States as of January 1, 1978—Continued

	Circulation
Texas—Continued	
League City: Clear Lake News Citizen	3,300
Longview:	
Journal	17,300
News	16,600
Lubbock: Avalanche-Journal	55,700
Mexia: News	3,500
Mineral Wells: Index	4,000
Mt. Pleasant: Tribune	4,700
Nacogdoches: Sentinel	8,200
Orange: Leader	11,500
Port Lavaca: Wave	4,100
Sulphur Springs: News-Telegram	5,500
Taylor: Press	5,600
Tyler:	
Telegraph	33,100
Courier-Times	9,400
Victoria: Advocate	28,500
Utah:	
Ogden: Standard-Examiner	47,000
Salt Lake City:	
Desert News	72,600
Tribune	102,400
Vermont:	
St. Johnsbury: Caledonian-Record	9,000
Virginia:	
Arlington: Northern Virginia Sun	19,200
Covington: Virginian	8,300
Danville:	
Register	9,900
Bee	15,600
Fredericksburg: Free Lance-Star	24,000
Hopewell: News	6,600
Newport News-Hampton:	
Press	54,173
Times-Herald	42,600
Staunton: Leader	16,800
Strasburg: Northern Virginia Daily	13,200
Washington:	
Centralia-Chehalis: Chronicle	14,900
Ellensburg: Record	5,500
Pasco-Kennewick-Richland: Tri-City Herald	33,600
Seattle:	
Journal of Commerce and Northwest Construction Record	5,400
Spokane:	
Spokesman-Review	73,700
Chronicle	62,600
Tacoma: News-Tribune	97,500
Vancouver: Columbian	37,400
Wenatchee: World	27,000
West Virginia:	
Bluefield: Telegraph	28,600
Buckhannon: Record	3,300
Charleston: Gazette	55,500
Clarksburg:	
Exponent	10,200
Telegram	20,800
Hinton: News	3,700
Keyser: News-Tribune	4,200
Logan: Banner	11,300
Morgantown:	
Reporter	4,900
Dominion-Post	14,700
Moundsville: Echo	5,100

Independent (non-chain) newspapers in the United States as of January 1, 1978—Continued

	Circulation
Wisconsin:	
Antigo: Journal	6,300
Beaver: Dam Citizen	8,900
Eau Claire: Leader-Telegram	33,300
Fort Atkinson: Jefferson County Union	6,500
Green Bay: News	10,200
Janesville: Gazette	28,900
La Crosse: Tribune	34,300
Madison: Capital Times	40,000
Marshfield: News-Herald	14,300
Milwaukee:	
Journal	338,600
Sentinel	168,700
Monroe: Times	8,200
Oshkosh: Northwestern	30,700
Racine: Journal-Times	40,600
Sheboygan: Press	31,200
Stevens Point: Journal	12,600
Watertown: Times	9,600
Waukesha: Freeman	24,400
Wisconsin Rapids: Tribune	12,400
Wyoming:	
Gillette: News-Record	5,200
Riverton: Ranger	6,100

Groups of dailies all within one State

Alabama:	
Anniston: Star	28,000
Talledega: Home, owned by H. Brandt and Edel Y. Ayers	10,600
Cullman: Times	6,900
Athens: News Courier, owned by Robert Bryan	6,600
Arizona:	
Yuma: Daily Sun	15,200
Kingman: Daily Miner	4,500
Prescott: Courier. Western Newspapers, Inc., owners are N. Soldwedel, etc	6,600
Arkansas:	
Pine Bluff: Commercial	22,000
Arkadelphia: Siftings Herald, owned by E. W. Freeman	3,500
DeQueen: Citizen	2,300
Malvern: Daily Record	4,900
Suttgart: Daily Leader, Ray Kimball Newspapers	4,500
California:	
Willows: Daily Journal	3,500
Orland: Daily Unit-Register, owned by Edwin Folsom Davis, also owns 8 weeklies in the region	2,900
Antioch: Ledger	11,900
Concord: Transcript	5,000
Contra Costa: Times, owned by Dean S. Lesher, also owns several weeklies	85,000
Sacramento: Bee	167,000
Fresno: Bee	107,500
Modesto: Bee, owned by McClatchy family	51,300
Corona: Independent	7,300
Ukiah: Journal, owned by Dean DeVries who also owns Carrolton (Mo.) Democrat	8,000
Madera: Tribune	6,400
Merced: Sun-Star, owned by Dean Stanley Lesher	19,800
Fremont: Argus	15,400
Hayward: Review	38,100
Livermore: Tri-Valley Herald, owned by Floyd L. Sparks	11,200
Connecticut:	
Norwich: Bulletin	33,500
Groton: News, owned by Harrison C. Noyes, Jr.	3,800

Groups of dailies all within one State—Continued

	Circulation
Georgia:	
Marietta: Journal	22,900
College Park-East Point-West End-Hapeville-Union City-Palmetto-Fairburn: South Fulton Today	2,800
Mableton-Austell-Power Springs: South Cobb Today	2,100
Roswell-Alpharetta: North Fulton Today, owned by Otis Brumby, Jr	2,000
Illinois:	
Centralia: Sentinel	17,400
Lincoln: Courier, Joy Newspapers—William V. Joy	7,800
Lawrenceville: Record	4,800
Robinson: News, Kent V. Lewis Newspapers	7,500
Arlington Heights: Herald	11,700
Des Plaines: Herald	3,100
Buffalo Grove: Herald	2,500
Elk Grove: Herald	3,700
Mount Prospect-Prospect Heights: Herald	8,500
Palatin: Herald	6,500
Rolling Meadows: Herald	2,900
Hoffman Estates-Schaumburg: Herald	6,500
Wheeling: Herald, Paddock Publications, Inc	1,900
Indiana:	
Columbus: Republic	20,700
Franklin: Journal	12,400
Greenfield: Reporter, Home News Enterprises—Robert N. Brown	5,600
Kendallville: News-Sun	6,000
Auburn: Star, Witwer Newspapers	5,300
Iowa:	
Waterloo: Courier	52,300
Cedar Falls: Record, W. H. Hartman Newspapers	5,100
Maine:	
Portland:	
Press Herald	53,500
Evening Express	29,800
Augusta: Daily Kennebec Journal	18,000
Waterville Central Maine Morning Sentinel, Guy Gannett Newspapers	24,000
Massachusetts:	
Malden: News	10,400
Medford: Mercury	8,300
Melrose: Evening News, Middlesex Valley Newspapers, David Brickman	3,200
Worcester:	
Telegram	56,100
Gazette	88,300
Hudson: Sun	3,700
Marlborough: Enterprise, Richard C. Steele	6,400
Michigan:	
Albion: Recorder	4,400
Marshall: Chronicle, Blair Bedient	3,100
Big Rapids: Pioneer	5,200
Manistee: News-Advocate, Connie Publishing Co.—Mrs. Harry Weitz	5,500
Minnesota:	
Mankato: Free Press	25,500
Owatonna: People's Press, Jared How—Free Press Newspaper	7,800
New Ulm: Journal	12,000
Fairmont: Sentinel	13,000
Marshall: Independent, Mickelson Media, Inc	5,500
Red Wing: Republican Eagle	9,400
International Falls: Journal, Red Wing Publishing Company—Phil Duff	5,500
Mississippi:	
Greenwood: Commonwealth	8,900
McComb: Enterprise-Journal, Emmerich Enterprises	12,000
West Point: Daily Times Leader	4,600
Starkville: Daily News, Harris Newspapers Inc	6,200

Groups of dailies all within one State—Continued

	Circulation
Mississippi—Continued	
Jackson:	
Clarion-Ledger	61,000
News	43,000
Hattiesburg: American, Hederman Newspapers	24,200
Missouri:	
Rolla: News	5,300
Waynesville: Guide	5,300
Columbia: Tribune	17,800
Fulton: Kingdom Daily News, Waters Newspapers	2,900
Nebraska:	
North Platte: Telegraph	17,200
Scottsbluff: Star-Herald	18,000
Lincoln: Journal, Western Publishing—Seacrest	29,500
New Hampshire:	
Keene: Sentinel	11,700
Lebanon: Valley News, Ewing-Payne Newspapers	12,200
New Jersey:	
Passaic-Clifton: Herald-News	82,500
Dover: Daily Advance, Drakker Newspapers	20,800
North Carolina:	
High Point: Enterprise	29,700
Burlington: Times-News	26,300
Thomasville: Times, Terry and Rawley Co-Publishers	7,100
Ohio:	
Elyria: Chronicle-Telegram	40,000
Medina: Medina County Gazette, Lorain County Printing & Publishing Co	14,400
Ashtabula: Star-Beacon	19,000
Conneaut: News-Herald	4,900
Geneva: Free Press	2,300
Painesville: Telegraph	16,700
Chardon: Geauga Times Leader, Rowley Northeast Ohio Group	8,300
Oklahoma:	
Sapulpa: Herald	7,900
Claremore: Progress	5,200
Edmond: Sun, Livermore Newspapers	6,800
McAlester: Democrat	9,500
Pryor: Times, Southeastern Publishers—Frances Stipe	4,200
Oregon:	
Albany: Democrat-Herald	18,900
Ashland: Tidings, Albany Dem.-Herald Publishing—G. Cushman	5,300
Bend: Bulletin	14,500
LaGrande: Observer	6,300
Baker: Democrat-Herald, Chandler Newspapers	3,100
Pennsylvania:	
Bedford: Gazette	6,500
Huntingdon: News, Biddle Newspapers	11,500
Clearfield: Progress	17,300
Danville: News, W. K. Ulerich Papers	4,300
Scranton City: Times	54,300
Towanda: Daily Review, Scranton Times	8,300
Erie:	
News	24,300
Times	51,200
Warren: Times Observer, Mead Newspapers	12,600
Hatboro: Today's Spirit	79,000
King of Prussia: Today's Post, Montgomery Publishing Co.—W. E. Strasburg	8,000
Beaver Falls-New Brighton: News-Tribune	18,700
Washington: Observer-Reporter, Northrop Newspapers	32,800
Berwick: Enterprise	7,700
Bloomsburg: Morning Press, Press-Enterprise, Inc.—P.R. Eyerly	12,100
Tennessee:	
Johnson City: Press-Chronicle	4,600
Lebanon: Democrat, Carl A. Jones Newspapers	7,800

Groups of dailies all within one State—Continued

	Circulation
Tennessee—Continued	
Greenville: Sun	13,700
Columbia: Herald	12,500
Athens: Post Athenian, John M. Jones Newspapers	8,000
Texas:	
Midland: Reporter-Telegram	20,200
Plainview: Herald, Allison Newspapers	9,100
Clear Lake-Pasadena: News Citizen	11,300
Conroe: Daily Courier, Attaway Investments, Inc	7,600
Athens: Review	5,500
Marlin: Democrat, Dwelle Newspapers	3,500
McKinney: Courier Gazette	6,400
Rosenburg: Herald-Coaster	6,000
Terrell: Tribune, Hartman Newspapers, Inc	5,300
Temple: Daily Telegram	23,500
Killeen: Daily Herald	14,900
Sherman: Democrat, Mayborn Newspapers	17,100
Arlington: Daily News	4,700
Grand Prairie: Daily News	6,700
Hurst Mid Cities: Daily News	6,400
Irving: Daily News	11,400
Garland: Daily News	12,700
Richardson: Daily News	8,100
Dallas: Morning News, A. H. Belo Corp	260,200
Mesquite: Daily News	4,100
Plano: Daily Star-Courier	8,900
Lewisville: Daily Leader, Taylor Communications	6,700
Levelland: Sun News	
Vernon: Daily Record	
Snyder: Daily News, Hockley County Pub. Co.	
Vermont:	
Rutland: Herald	21,100
Barre-Montpelier: Times-Argus, Rutland Herald Newspapers	11,700
Virginia:	
Harrisonburg: Daily News-Record	26,800
Winchester: Star, Byrd Newspapers	18,200
Lynchburg:	
News	20,500
Advance	19,500
Culpeper: Star-Exponent, Carter Glass Newspapers	5,600
Pulaski: Southwest Times	-6,000
Radford: News Journal, New River Newspapers—D. G. Rooker	4,700
Washington:	
Longview: News	25,800
Bellevue: Daily Journal-American	25,200
Port Angeles: News, McClelland Newspapers	12,000
West Virginia	
Charleston: Daily Mail	56,000
Beckley:	
Post Herald	20,500
Raleigh Register, Clay Communications, Inc	12,500
Wisconsin:	
Chippewa Falls: Herald-Telegram	9,000
Baraboo: News-Republic	5,900
Portage: Daily Register	7,800
Shawano: Evening Leader, Lavine Newspaper Group	7,200
Wyoming:	
Cheyenne:	
Wyoming Eagle	8,600
Wyoming State Tribune	11,000
Laramie: Boomerang	6,800
Rawlins: Times	4,100
Rock Springs: Rocket	6,100
Worland: Northern Wyoming News, McCracken Newspapers	4,200

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Memorandum

Re Independent Local Newspaper Tax Act—Section 529, Advance Estate Tax Payment Trust; and Section 6166B, Extended Payment of Estate Tax.

CURRENT LAW

Generally an estate tax return is due nine months after the decedent's death and, except in certain specified situations, payment of the estate tax is required to be made with the return.

Current law contains several provisions which permit the extended payment of the estate tax for periods of up to 10 years, and in one case of up to 15 years, from the regular due date on the tax (secs. 6166 and 6166A). To fund payment of the estate tax, capital gains treatment is afforded a corporate distribution in redemption of stock to the extent that the amount of such distribution does not exceed estate and death taxes, administration expenses, and funeral expenses (sec. 303).

However, the extended payment provisions are premised upon the existence of a pressing "liquidity" problem which would result from regular payment of the estate tax when the assets of a closely held business comprise all or a very substantial percentage of the estate. When the owner of an interest in an independent local newspaper cannot meet the percentage restrictions, he is faced with the necessity of liquidating his interest to a chain newspaper in order to fund payment of the estate tax. Capital gains treatment for redemptions is likewise restricted by a significant percentage limitation. Neither the extended payment provisions nor the redemption provision encourages continued independent local ownership of newspapers or takes into account the vital public interest in preserving competitive local newspapers in all parts of the United States.

Estate tax extensions.—Current law generally provides for deferred payment of the estate tax in the following circumstances:

(1) The Internal Revenue Service may extend payment of the tax for a period of up to 10 years for "reasonable cause", such as needed time to collect receivables or to convert assets into cash (sec. 6161(a)(2)).

(2) In addition, an executor may elect to extend payment of the estate tax over a period not to exceed 10 years where the value of the decedent's interest in a closely held business exceeds 35 percent of the value of the gross estate or 50 percent of the decedent's taxable estate (sec. 6166A). However, only that portion of the estate tax attributable to the closely held business may be extended.

(3) Alternatively, the executor may elect to extend payment of the tax for a longer period of up to 15 years if the value of the decedent's interest in a closely held business exceeds 65 percent of the decedent's adjusted gross estate (sec. 6166(a)). The tax (but not interest thereon) may be deferred for up to 5 years and then paid in equal installments over the next 10 years. The rate of interest is 4 percent on the deferred tax attributable to the first $1 million of closely held business property, and 6 percent on the remainder.

Capital gains treatment.—A distribution of property to a shareholder by a corporation in redemption of corporate stock which is included in the gross estate of a decedent is afforded capital gains treatment if certain percentage restrictions are satisfied. The redemption must be accomplished by a corporation whose stock comprises more than 50 percent of the value of the decedent's gross estate reduced by losses, debts, and administration expenses. Furthermore, this special capital gains treatment is available only as to that amount of the distribution which does not exceed estate taxes and administration and funeral expenses.

CURRENT LAW APPLIED TO INDEPENDENT NEWSPAPERS

The extension of payment provisions are intended to alleviate the liquidity problems experienced by estates in which the assets consist largely of a closely held business. The redemption provision is designed to facilitate the use of corporate assets to fund payment of the estate tax where the closely held business constitutes a substantial part of the estate of the decedent. These provisions do not reach the vital public interest in preserving independent local newspapers where the estate includes an interest in such a newspaper, but the percentage restrictions imposed by current law are not met. In such a case, corporate assets would not be available to fund payment of the estate tax, and the executor would be faced with prompt payment of the estate tax in full. The serious liquidity

problems entailed in meeting the estate tax in such circumstances is calculated to encourage disposition of the newspaper to chain publishers to raise the required cash funds.

Congress has declared that it is the public policy of this country to maintain an independent and competitive newspaper press in all parts of the United States. (15 U.S.C. § 1801 (1970)). When the executor of an estate which includes an interest in an independent local newspaper is forced to liquidate a portion or all of that interest in order to pay the estate tax, the dominant buyers are inevitably the large owners of newspaper chains. The Congressional policy of preserving independent newspapers is thereby frustrated.

For example, if the owner of an interest in a local newspaper wished to pass on to the next generation $1 million of newspaper assets, he would need at least $1.5 million in assets before estate taxes since the effective rate on $1.5 million is approximately 40%, leaving $1 million after taxes. To pass on $2.5 million of newspaper assets, he would need $4 million before estate taxes. In order to pass on $5 million of newspaper assets the decedent would need $13.6 million in assets in order to fund $8.5 million in estate taxes incurred at an effective rate of approximately 70%. In addition, if corporate assets are to be used to fund payment of the estate tax, applicable income taxes would further increase the funds needed to maintain local independent ownership of a newspaper. While these figures will vary depending on each local newspaper owner's personal circumstances, the ultimate conclusion is the same: the combined income and estate tax burden of current law encourages the disposition of interests in local independent newspapers to large chain publishers unless the stringent per shareholder ownership requirements of current law can be satisfied. More important, it is less likely that these ownership requirements can be met in second or third generation owned local independent newspapers.

This is borne out by the fact that the total number of daily newspapers has remained at approximately 1775 newspapers from 1954 to 1974, yet the percentage of those dailies owned by chains controlling 2 or more newspapers has increased dramatically from 27% to 55% during that period, and the trend has accelerated since 1974. W. Baer, H. Geller, J. Grundfest & K. Possner, Concentration of Mass Media Ownership 37 (September 1974) (The Rand Corporation). During a similar period, the number of U.S. cities with competitive daily newspapers fell from 117 to 55. (*Id.*, 35). The impact of the current estate tax provisions on this trend of lessened competition cannot be doubted.

NEW SECTION 529

Section 529, Independent Local Newspaper Advance Estate Tax Payment Trust, provides for the adoption by a local independent newspaper of a plan authorizing the creation of a trust for each individual who has an interest in the newspaper for the sole purpose of funding payment of the individual's estate tax which is attributable to his interest in the newspaper. The trust will receive contributions exclusively from the newspaper and will invest its assets solely in U.S. government obligations. Upon an individual's death, the trust assets will be used exclusively for payment of his estate tax. The net effect of the provision thus redounds to the benefit of the federal government by making monies earmarked for payment of future estate taxes immediately available. The liquidity problems faced by individuals who cannot qualify for special treatment under current law also would be alleviated. The need to raise funds for estate taxes, even with an extension for payment, would not force their executors to press for the sale of a local independent newspaper to large chain publishers. The provision, therefore, permits an independent local newspaper to arrange for the advance payment of estate taxes to the government in order to maintain its independent status.

EXPLANATION OF PROVISIONS

In general.—The provision requires an independent local newspaper to adopt a plan permitting for the creation of a qualified trust for each individual who has an interest in the newspaper for the exclusive purpose of funding payment of the individual's estate tax attributable to his interest in the newspaper. To be a qualified trust, the trust, among other things, must be created in the United States for an individual who has interest in the newspaper, must be created pursuant to the plan adopted and must have a governing instrument providing the following: trust assets are to be invested solely in obligations of the United

States; contributions are to be made exclusively by the newspaper during the individual's lifetime and, after his death, prior to payment of his estate tax; trust assets are to be devoted exclusively to payment of the individual's estate tax which is attributable to his interest in the newspaper; and any excess funding of the trust is to be distributed promptly to the individual if living or if deceased to his estate. Finally, the plan adopted by the newspaper must require that the contributions to the qualified trust be made exclusively by the newspaper solely for the purpose of payment of the estate tax. In order to limit use of the trust to its essential purpose and to curtail the potential for abuse, an individual who has an interest in more than one newspaper may be the beneficiary of a qualified trust only with respect to his interest in one independent local newspaper business, and then only if his newspaper interests do not constitute a newspaper publishing chain under the applicable definition. In addition, where a newspaper business is conducted by a partnership or corporation which is also engaged in other business activities, the contributions to the trust are limited to the value of the partnership or corporate stock interest attributable to the newspaper business (determined as separate going concern), and to minimize value allocation problems in such circumstances, provision is made for the spin-off of the other business operations subject to specified restrictions.

Tax treatment.—The exclusive purpose of the newspaper trust is to permit advance funding of the estate tax to preclude the need for disposition of newspaper assets, and it would therefore be inappropriate to impose a tax on trust assets, contributions or distributions. A qualified trust is therefore exempt from taxation, provided the trust is administered in conformity with the requirements for qualification in its governing instrument and in accordance with applicable regulations.

An individual who is the beneficiary of a qualified trust, and his estate, will not be taxed on contributions made to the trust by the independent local newspaper business and, in the case of his estate, on distributions made by the trust in payment of the estate tax. In order to preclude questions of constructive receipt, contributions to any qualified trust are deemed to be exempt from taxation to any individual participating in the independent local newspaper's advance estate tax payment.

An independent local newspaper business can contribute an amount each year not in excess of 50 percent of its taxable income for the year from its newspaper operations and deduct such amount as an ordinary and necessary business expense. No deduction is allowed, however, to the extent that any contribution results in excess funding of the trust.

Termination of tax exempt status.—Excess funding of the trust will not only cause the newspaper to lose its deduction, but it will cause the individual or his estate to realize income in the amount of the excess funding. The trust is excess funded when the fair market value of the trust assets exceeds the estate tax attributable to the decedent's interest in the newspaper. In addition, during an individual's lifetime contributions to the trust may not exceed 70 percent of the fair market value of his interest in the newspaper business. Excess funding of the trust thus occurs either when the assets exceed the highest marginal rate of estate tax that can be imposed, or when trust assets exceed the actual estate tax attributable to the decedent's interest in an independent local newspaper business.

There are a number of events which can cause a trust to become excess funded. If any part of an individual's interest in the independent local newspaper business is sold or exchanged, or if such interest is traded in an established securities market, or if the newspaper ceases publication, or is sold to a chain of newspaper publications or otherwise, excess funding will result. In such a case, the amount of any excess funding is treated as distributed to the individual and is includable in his gross income. In the case of a decedent, the amount of any excess funding is treated as distributed to the decedent's estate and is includable in the gross income of the estate as income in respect of a decedent. In addition, the amount of any excess funding is includable in the decedent's gross estate for estate tax purposes (which may necessitate a recalculation of the estate tax).

In addition, in the case of excess funding, the independent local newspaper will recapture any tax deductions taken for prior contributions which resulted in a tax benefit to the newspaper. Specifically, the newspaper must include in gross income the lesser of the amount of such excess funding or its prior contributions to the trust as to which the tax benefit was realized.

A qualified trust will lose its tax exempt status entirely if it is not administered in conformity with the requirements for qualification specified in its governing

instrument, or in accordance with the regulations prescribed by the Secretary to carry out the purposes of the trust. Upon the occurrence of an event which causes the trust to lose its tax exempt status, all of the assets of the trust are treated as distributed as described above. By these restrictions on the manner in which a qualified trust can be administered and the use to which trust assets can be put, the potential for tax avoidance is removed, and owners of interests in independent local newspapers are encouraged to make a significant economic commitment toward preserving their interests in the newspapers.

Explanation of other provisions.—An independent local newspaper is limited to a newspaper publication which has all its publishing offices in a single community and is not one of a chain of newspaper publications. A chain of newspaper publications means two or more newspaper publications published in different communities and owned, directly or indirectly, by the same person or persons.

An interest in an independent local newspaper business includes an interest in a proprietorship or an interest in a partnership or corporation which has none of its outstanding partnership or stock interests traded in an established securities market. Moreover, in the case of a partnership or corporation, the outstanding partnership or corporate stock interests will qualify as an interest in an independent local newspaper business only to the extent the value of such partnership or corporate stock interest is attributable to the newspaper business (as a separate going concern). In addition, in determining whether a newspaper is an independent local newspaper business, commonly controlled corporations are treated as a single corporation where the same parties in interest own at least 50% of the total combined voting power of all classes of stock entitled to vote, or at least 50% of the total value of shares of all outstanding classes of stock of such corporation. This is done in order to prevent a chain of newspaper publications from reorganizing into several corporations to take advantage of this section.

The estate tax attributable to an interest in an independent local newspaper business means the excess of the amount of tax imposed by section 2001 over the tax that would have been imposed if no interest in an independent local newspaper had been included in the gross estate of the decedent. The tax deferred is thus the tax that would not have been paid but for the inclusion of the newspaper assets in the estate, which of course is the tax at the highest marginal rate. This provision by deferring the tax at the highest marginal rate, operates as an added incentive to keep newspapers independent and local.

The value of an interest in a partnership or corporation which is attributable to an independent local newspaper is determined by apportioning the net fair market value of the newspaper (determined as a separate going concern) proportionately among all outstanding partnership or corporate stock interests, with appropriate adjustment for limited equity interests such as preferred stock. This is done to minimize valuation problems and potential valuation controversies. To facilitate the allocation of values where a corporation is engaged in business activities in addition to newspaper publication, the corporation is permitted to spin-off, through means of a separate corporation, its non-newspaper operations. This spin-off must however, satisfy the active business requirements of section 355 for both the five-year period immediately preceding and following the spin-off, a total of ten years, except for a change of business after the spin-off due to involuntary conversion, governmental order and the like. In addition, the distributee shareholders (and in the event of death and the like, their successors-in-interest) must intend to, and must in fact, retain a controlling stock interest, as defined in section 368(c), in both corporations for the five-year period following the spin-off. This is done to prevent any possible use of the spin-off for tax advantage.

Under current law, the carryover basis of property inherited from a decedent dying after 1976 is generally the decedent's adjusted basis in the property immediately before his death. If the fair market value of the property exceeds its adjusted basis, the carryover basis in such appreciated property is increased by federal and state taxes. However, under this section the estate tax attributable to an interest in an independent local newspaper business will be paid out of the assets of a qualified trust, and the carryover basis in such an interest would therefore not be increased by payment of estate taxes. This increases the potential capital gains which would result from a subsequent disposition of newspaper assets, creating another incentive to maintain independent local ownership of newspaper assets.

EFFECTIVE DATE

This section is applicable to trusts created on or after October 31, 1977.

NEW SECTION 6166B

Section 6166B, Extension of Time For Payment of Estate Tax Where Estate Includes Interests in Independent Local Newspaper, applies the 15 year extension provision of current law to an estate comprised in part of an interest in an independent local newspaper. No percentage restrictions are imposed. By this method, estate taxes would not cause the sale of interests in local independent newspapers to large chains, and independent ownership of local newspapers would be encouraged.

EXPLANATION OF PROVISIONS

In general.—When an estate includes an interest in an independent local newspaper, the executor may elect to defer payment of part or all of that portion of the estate tax attributable to the interest in one such newspaper (but not the interest on the tax) for up to 5 years, and then to pay the tax in equal yearly installments for up to 10 years. Interest on the amount of tax extended would be payable at the same rate as that prescribed in section 6601(j) for other extensions of the estate tax. If a deficiency has been assessed, the deficiency may be prorated to the installments.

In order to limit use of the extended payment to its essential purpose and to curtail the potential for abuse, the executor of an estate which includes an interest in more than one newspaper may elect to defer payment of the estate tax attributable to one, and only one, interest in an independent local newspaper, and then only if the decedent's interest in more than one newspaper did not constitute an interest in a chain of newspaper publications. In addition, where a newspaper business is conducted by a partnership or corporation which is also engaged in other business activities, the contributions to the trust are limited to the value of the partnership or corporate stock interest attributable to the newspaper business (determined as separate going concern), and to minimize value allocation problems in such circumstances, provision is made for the spin-off of the other business operations subject to specified restrictions.

Acceleration of payments.—If any part of the interest in an independent local newspaper is sold or exchanged, or if corporate stock is traded in an established securities market, the extension of time for payment of the tax attributable to the interest disposed of or traded ceases to apply, and the unpaid portion of the tax attributable to such interest is payable upon notice and demand from the Secretary. This provision does not apply to transfers pursuant to a reorganization which constitutes a mere change in identity, form, or place of organization, or to a transfer by the executor to a person entitled to such property under the decedent's will or under the applicable law of descent and distribution.

If the newspaper ceases to qualify as an independent local newspaper by reason of ceasing publication, becoming part of a chain of newspaper publications, or otherwise, the unpaid portion of the tax payable in installments becomes due upon notice and demand.

Finally, if any installment is not paid on or before the date fixed for its payment, the unpaid portion of the tax payable in installments is likewise to be paid upon notice and demand.

Explanation of other provisions.—The provisions relating to independent local newspaper, a chain of newspaper publications, an interest in an independent local newspaper, and the estate tax attributable to such an interest, are essentially identical to the corresponding provisions of section 529.

EFFECTIVE DATE

This section is applicable to decedents who die after October 31, 1977.

CONCLUSION

Section 529 permits an independent local newspaper business to adopt a plan for the creation of Estate Tax Payment Trusts, the assets of which are invested solely in United States obligations, for the purpose of funding the estate tax attributable to the interest of its individual owners in the newspaper, and thus avoid any need for the sale of the paper to a large chain publisher in order to raise the funds necessary to pay applicable estate taxes. Trust assets are limited

to an amount which is reasonably necessary to pay the estate tax attributable to the newspaper interest by denying any tax advantage to excess funding. Section 6166B provides for a 15 year extension of payment of the estate tax on interests in local independent newspapers, with no percentage restrictions. These two sections operate together to prevent the adverse national and local consequences caused by the disposition of independent newspapers to large chain publications in order to fund the estate tax.

The advance payment trust serves as the immediate vehicle for encouraging continued local and independent ownership of newspapers, and the extension of time for payment of estate taxes from the decedent's assets serves the same purpose in circumstances where advance payment is not possible. A significant number of years is required before a trust can be adequately funded. In the meantime, an extension of payment provision is required in order to extend to executors the time to raise funds to meet the estate tax in some way other than by selling newspaper assets. Secondly, there will be a tendency for trusts to be underfunded due to continuing inflation and in order to avoid the penalties attaching to excess funding. Therefore, a significant portion of estate tax will remain to be paid by the executor, and an extension of time for payment will be necessary to insure that a sale of the independent local newspaper is not necessary to fund such payment. Sections 524 and 6166B together provide substantial and meaningful incentives for independent local newspapers to remain local and independent.

Statement of National Newspaper Association

Mr. Chairman: My name is W. Terry Maguire and I am the general counsel to the National Newspaper Association.

We are offering this separate statement—in addition to the views expressed today by Mr. Prescott Low on behalf of the American Newspaper Publishers Association—because we want this Subcommittee to know that the issue before you is of great interest to our members. Full consideration of estate tax reform as a means to encourage independent ownership of businesses has a high priority within our association's legislative program.

NNA appreciates the deep commitment to a free and independent press expressed by Senator Morgan in introducing this legislation. NNA members pride themselves on their editorial independence in serving their local communities across the U.S. Taxes, an inefficient and expensive postal service, and other rising operating costs all pose serious threats to the smaller newspapers of this country.

Our Board of Directors went on record last year in support of efforts to "work with Representative Udall * * * to make [his bill] as acceptable as possible to newspapers and to broaden it to include small businesses." In addition, our task Force on Newspaper Ownership has stated that "the preservation of independent, local and individually owned newspapers is a desirable goal." The Task Force views "estate tax law revision as one method of achieving this goal."

We already have indicated our desire to meet with Senator Morgan to discuss this legislation. Should members of the staff of this Committee wish to meet with us, we would welcome that opportunity as well.

Finally, we felt that the Subcommittee might wish to review some of the information and views which the more than 10,000 newspaper subscribers of Publishers' Auxiliary have received concerning this legislation. This is but one indication of the importance which our industry attaches to this subject. Publishers' Auxiliary will continue its independent coverage of this issue in the months ahead. (NNA owns Publishers' Auxiliary, but the weekly newspaper is recognized for its own editorial integrity.)

Mr. Chairman, NNA plans to explore all possible solutions to the estate tax problems which face our member community newspapers. As we continue to address this issue, we will keep you and Senator Morgan informed about our progress.

[From Publishers' Auxiliary, Dec. 12, 1977]

Wrongheaded Notion

Nearly two months ago Rep. Morris K. Udall (D.-Ariz.) introduced legislation designed to preserve the shrinking voice of the nation's independent newspaper.

The legislation would give the owners of independent newspapers certain alternatives which would allow them to escape the sometimes ruinous effects of inheritance taxes.

At the same time, the legislation would effectively slow the growth of newspaper chain ownership.

Rep. Udall's bill—known as the Independent Local Newspaper Act (H.R. 9484)—faces, as nearly all legislative proposals do, a complicated and lengthy existence. Some people—for the most part those who support the bill—suggest that the legislation has a better than even chance of winning congressional approval. What will insure passage of the legislation, these people say, is a supportive effort by the newspaper industry.

Only recently, publishers of some independent newspapers began work on the formation of an organization called the Independent Local Newspaper Assn. If the organization becomes a reality—and there is ample evidence to suggest that it will—its aim is to spend at least $150,000 lobbying for adoption of Rep. Udall's bill.

There doubtless are many of our colleagues who will applaud the aim of the publishers involved in this new organization. Publishers' Auxiliary, however, believes that the idea of such an organization is a wrongheaded notion, one destined to lead to divisiveness. More important, it would direct attention away from one of the most important conversations to be conducted in the industry in years.

Rep. Udall, by introducing H.R. 9484, has at long last forced the newspaper industry to take a hard look at the merits of newspaper chain ownership, and at what some suggest are the inherent dangers of the concentrated ownership.

Although Rep. Udall tells us his aim is the preservation of independent newspapers—a noble idea—there should be no misunderstanding about his overriding concern: namely, that newspaper ownership concentration could lead to a dangerous sameness in the newspaper product.

The publishers who seek to create the Independent Local Newspaper Assn. apparently are impatient and disturbed that no major industry trade organization has embraced Rep. Udall's proposal. To these publishers, we should point out that no major industry organization has come out in opposition to it, either.

Rep. Udall's proposal is a complicated piece of legislation. As such, it should be approached with caution. Reckless impatience, we should remember, has brought us close to disaster before.

For example, many of our colleagues sought to compromise the principles of the press during the battle for passage of the federal Freedom of Information Act. Luckily, those voices were overriden—as was President Ford's veto of the FOI Act.

There are many people in our industry who support Rep. Udall's idea, if not his proposed legislation. If his idea is to ever become reality, it will take a united industry front to accomplish it.

The ILNA would put the industry out of step. Furthermore, Rep. Udall's proposal would remain simply that, a proposal.

[From Publishers' Auxiliary, Dec. 12, 1977]

INDEPENDENT GROUP TO LOBBY IN SUPPORT OF UDALL BILL

WASHINGTON.—Publishers of some of the nation's independently owned newspapers are working for the creation of a well-financed association to lobby for adoption by the Congress of Rep. Morris K. Udall's Independent Local Newspaper Act.

Generally, Udall's bill seeks to encourage the preservation of independent daily and weekly newspapers by amending the Internal Revenue Code to allow the establishment of a trust account which could be used to pay off the often crippling obligations of estate taxes.

Publishers' Auxiliary has obtained a copy of a letter from John Wolfe, publisher of the Columbus (Ohio) Dispatch and one of the executives involved in the creation of the independent association, in which Wolfe urges a publishing colleague to join him and other publishers in discussions concerning formation of the organization.

In his letter Wolfe said the organization would be used "as a vehicle through which to manifest our support (for the Udall bill).

"Our present intent," Wolfe said in the letter, "is to retain (Morris) Levin (a Washington lawyer who specializes in antitrust law) as our lobbyist, and he will register on behalf of ILNA."

The projected budget for the organization, Wolfe told his colleague, "will be $150,000 per year." Additionally, Wolfe said that each member of the organization would make an initial payment of "from $5,000 to $8,000 to cover the operating budget, and that the payment of any contingency would be raised by an assessment based on circulation (no more than 25 cents per copy)."

The lawyer Wolfe proposes that ILNA engage as its lobbyist, Morris Levin, has worked closely with Udall in drafting the bill, H.R. 9484.

In an interview, Levin confirmed that he has talked with publishers of some independently owned newspapers about the creation of the association. However, he would not identify any of the publishers.

Asked if he considered Wolfe's proposal that he become the organization's lobbyist to be a conflict of interest—in as much as he had helped write the Udall bill--Levin said no.

According to Levin, he has assisted Udall in the drafting of the bill without payment, a situation, he said, "which I cannot afford to continue."

As for the independent organization, Levin said, "If it's formed—and that's still an 'if'—I'm sure it wouldn't have a large staff. Anyway, that wouldn't be up to me."

He also said it was his understanding that the organization "wouldn't be competitive with any other (newspaper association)."

Asked why the organization should be created, Levin said that although the Udall measure stands a "reasonably good chance" for adoption, it "needs help."

The legislation, he said, could be "furthered by a supportive body." The bill could be helped, he said, "if everybody got behind it."

The nation's major newspaper trade associations—the National Newspaper Assn. and the American Newspaper Publishers Assn.—have not endorsed the bill.

In a statement issued not long after Udall introduced his bill in the House, ANPA president and chairman Joe D. Smith, publisher of the independent Alexandria (La.) Daily Town Talk, said the association "has previously suggested that Congress give its attention to inequities in tax laws affecting businesses, including newspapers." Smith said the association applauded the Udall bill "as an important first step in this area."

NNA's board of directors, during its meeting recently in Houston, directed the association's staff to work with Udall on the bill to "make it as acceptable as possible to newspapers and to broaden it to include small businesses . . ." The board went on to say that it reserved the right "to oppose the legislation if it cannot be made acceptable to newspapers . . . in its final form."

Udall, however, has mistakenly told a House committee that the associations have endorsed his proposal.

In testimony before the House Monopolies and Commercial Law Subcommittee last week, Udall said the bill has "received the endorsement of the American Newspaper Publishers Assn., the president of the American Society of Newspaper Editors and the National Newspaper Assn."

In a letter to Udall, NNA Executive Vice President William G. Mullen, said the association "has not endorsed the bill." Mullen also requested that "the record of (the subcommittee's) proceedings be so clarified."

A spokesman for ANPA said the association is not backing "every line of the bill." He said he was "confident that (ANPA chairman and president Smith) did not intend to endorse it. We want to work with Udall and others to improve it. It's an issue which needs addressing."

Udall, who has warned of "disturbing social implications" from increased concentration of newspaper ownership, has urged congressional approval of his bill—which would change estate tax laws to induce owners of independent newspapers not to sell their properties.

To qualify for the proposed estate tax relief, the newspapers could not be part of a chain or publicly traded corporations.

A major factor in the increased concentration of newspaper ownership, Udall has said, has been "the devastating effect" of estate taxes upon owners of the independent newspapers.

"More and more newspaper owners, in contemplation of the fact that their estates will not be able to both pay the estate taxes and maintain their news-

papers, have opted to sell their newspapers in tax free exchange for the stock of chains and other publicly traded corporations," he has said.

Udall has approximately 40 cosponsors for the legislation. Hearings have not been scheduled by the Monopolies and Commercial Law Subcommittee. Udall's appearance before the subcommittee last week involved his sponsorship of another piece of legislation with newspaper publishing implications—his so-called Competition Review Act.

Generally, the legislation calls for the creation of a congressional commission to study the effects of economic concentration in some of the nation's major industries, including the newspaper industry. (See story in Washington Report, page 15.)

[From Publishers' Auxiliary, May 1, 1978]

UDALL INTRODUCES "FINE-TUNED" VERSION OF TAX ACT

(By Andrea Chancellor)

WASHINGTON.—Rep. Morris K. Udall (D.-Ariz.) has begun a new campaign to check the growth of newspaper chain ownership by introducing another version of a bill designed to preserve independent newspapers.

Udall last week introduced what some observers said was a "fine-tuned" version of a bill he put into the congressional hopper last year, his so-called Independent Local Newspaper Tax Act.

Several sources said the timing of the bill's introduction was keyed to capture the attention of newspaper publishers gathered in Atlanta this week for the annual American Newspaper Publishers Assn. convention.

The Independent Local Newspaper Assn., a group created last year to lobby for support of the earlier Udall bill, has scheduled two meetings for ANPA members on the new proposal.

In letters to colleagues on Capitol Hill, Udall said his new version of the bill tightens some of the earlier provisions which he said were "too generous." The only major change in the bill, however, adds a provision to allow newspapers or groups of newspapers located within one state to take advantage of certain estate tax concessions.

Udall emphasized last week that the bill would not lead to regulations of the nation's newspaper industry. Instead, he said, it would assure the preservation of the hometown newspaper.

His new bill, like the earlier one, would allow a newspaper owner who meets certain qualifications to set aside money from profits for payment of estate taxes.

Additionally, following an owner's death, estate tax payments could be deferred by heirs for a limited period.

Morris Levin, a lobbyist and counsel to the Independent Local Newspaper Assn., said last week he is optimistic the House Ways and Means Committee will act on the new Udall proposal.

He said introduction of the earlier bill was an attempt by Udall to draw attention to the concept and prompt newspapers and newspaper trade publications to generate coverage of the issue.

"We did not ask for hearings up to now," Levin said in an interview. "All we wanted to know was what the industry thought of the bill."

A spokesman for the Ways and Means Committee said late last week that there are no plans for consideration of either Udall proposal because, as she put it, committee members are "just not in the mood."

She said the critical issue in the Udall legislation is the carry-over of the estate tax burden to survivors. She said this is a major tax issue which the committee members do not want to address at this time.

"The problem (Udall) is trying to address is not unlike the problem in many other businesses," she said.

Udall aides were confident last week, however, that the new bill will alleviate any concerns the newspaper industry had over the earlier version.

One Udall aide, Bob Neuman, will address newspaper publishers at one of the meetings called by ILNA in Atlanta. Rep. Ted Risenhoover (D.-Okla.), one of the bill's cosponsors, also will talk about the bill to ANPA members. Risenhoover is publisher of the Tahlequah (Okla.) Pictorial Press and the Star Citizen.

[From Publishers' Auxiliary, Mar. 20, 1978]

UDALL APPEALS FOR TAX BILL SUPPORT

ATLANTA.—Rep. Morris Udall (D.-Ariz.) appealed to groups of newspaper publishers this month in search of support for legislation he's sponsoring to preserve small, independent newspapers.

He told members of the Southern Newspaper Publishers Assn. here that unless present economic and tax law conditions change, it is possible that every daily newspaper in the country could be under direct control of a handful of communications conglomerates.

He said current tax laws permit tax-free stock transfers and the "brutal burden of estate taxes make retaining a newspaper by a family nearly impossible in the face of huge financial offers of the big chains."

He called on the publishers to support his bill, the Independent Local Newspaper Act, H.R. 9484, which would amend the Internal Revenue Code to allow independent newspaper publishers to contribute up to 50 percent of the newspaper's earnings into a trust fund to pay off estate taxes.

The bill also would extend to 15 years the period in which estate taxes must be paid.

In remarks earlier this month before the annual National Newspaper Assn. Government Affairs Conference, Udall predicted that the trend in chain ownership of newspapers will peak in 15 years when as few as six communications conglomerates will tell the American public what to read.

"Something has been wrong in the newspaper business when family owned and small newspapers are forced from the market" by tax laws and an economic system weighted in favor of large corporations.

"It's bad news for the consumer, it's bad news for freedom, it's bad news for diversity" when the majority of American newspapers are owned by newspaper chains, he said.

He said 97 percent of cities with daily newspapers have either one newspaper or newspapers that are owned by a single publisher. Too often the publisher doesn't live in the city, he said, adding, "it's a bad situation and I don't like it."

[From Publishers' Auxiliary, May 1, 1978]

MR. UDALL'S BILL

The somewhat imperceptible Independent Local Newspaper Assn. plans to put on a big show during the American Newspaper Publishers Assn. convention this week in Atlanta to lobby for support of Rep. Morris K. dall's attempt to restrain the growth of newspaper chains.

The ILNA, you may recall, was created late last year by publishers of independent newspapers. Since its creation it has remained largely invisible, its members choosing to work as inconspicuously as possible for Rep. Udall's bill, the so-called Independent Local Newspaper Tax Act.

Among other things, Rep. Udall's bill would make it easier for the heirs of independently owned newspapers, through the creation of certain inheritance and estate tax concessions, to keep the newspapers in the family—and out of the hands of newspaper chains.

That the members of ILNA are interested—some would say worried—about the demise of the independently owned newspaper is commendable. Their interest—and worry—is shared by others.

It is not to their credit, however, that they have gone outside the established organizations of our industry to lobby for support of Rep. Udall's bill.

There is ample evidence that we could achieve more as an industry if the dozens of associations, societies, organizations and the like would take unified positions on more of the issues that affect us. The action of the members who have created the ILNA is divisive. Further, it borders on the reckless.

To date, the ILNA has done nothing more than urge that we blindly support Rep. Udall's proposals. It has offered us no concrete reason why we should do so. This is nonsense. This tactic points out that ILNA members have not done much homework. Further, it suggests that the organization is getting bad advice.

Rep. Udall's bill appeals to emotions. And, to be sure, the preservation of the independently owned newspaper is an emotional issue.

During the last few years, newspaper chains have been painted as our industry's chimera. But the chains are not as monstrous—or as virtuous—as they are made out to be.

There is a very important consideration in the Udall bill that should—but does not—bother the ILNA. That is, the bill would give our industry yet another special privilege.

Our industry has been hounded by its critics because of the privileges we already enjoy, namely those offered to us under the First Amendment. Do we really want—and can we afford—another one?

Some people in our industry have suggested that a better approach might be one that would offer the same type of tax concessions to a variety of family owned, independent businesses, including newspapers. Such a proposal would have the same result as that offered by Rep. Udall, they suggest.

Publishers Auxiliary recommends that members of the ILNA give this notion consideration. It is far more logical and far less selfish.

TREASURY OPPOSES UDALL'S ESTATE TAX PLAN; MORGAN PLANNING SENATE VERSION

Washington.—A Treasury Department official told a House subcommittee last week that the department opposes a bill designed to give estate tax relief to the owners of independent newspapers.

Calling the bill "another example of special relief leigslation," the treasury official, Daniel I. Halperin, said the measure is a "significant departure from accepted tax principles. . . ."

The bill is H.R. 12395, Rep. Morris K. Udall's so-called Independent Local Newspaper Act. The Arizona Democrat's proposal would allow the owners of independent newspapers who qualify to put money from profits into a tax-exempt trust account for payment of estate taxes. The money put into the account could be deducted by the newspaper for income tax purposes. Additionally, following an owner's death, the bill would permit heirs to defer estate taxes not covered by the trust—whose assets also would be tax-exempt—for a limited period.

In addition, Udall's proposal would allow the owners of newspaper chains—whose newspapers are published in a single state—to take advantage of the bill's provisions. However, newspapers or chains whose stock is traded in an established securities market could not take advantage of the bill's provisions. (See a description of the bill on page 2.)

In a related development, Publishers' Auxiliary has learned that Sen. Robert Morgan (D-N.C.) plans to introduce a Senate version of the Udall bill.

An aide to Morgan said the senator's proposal "at this time is identical to Udall's bill." According to the aide, the senator is attempting to line up cosponsors for the bill before introducing it.

When—and if—the bill is introduced, it likely will be assigned to the Senate Finance Committee.

In his testimony before the House Miscellaneous Revenue Measures Subcommittee, Halperin, who is acting deputy assistant secretary of the Treasury Department's Office of Tax Policy, said the department is sympathetic "to the plight of some some owners of small business in planning the payment of estate taxes while retaining control of their business in their heirs." However, he said, the department opposes "this special relief for one group of 'small businesses.'

"As valuable as a free and vigorous press is to this nation," he told the subcommittee, "we do not believe that an ownership interest in such business should be free from tax."

If independent local newspapers have particular problems arising from their economic circumstances, he said, "the tax expenditure method may be one of the least controllable methods of dealing with them. For instance, special loan programs might be considered."

In addition, Halperin said that to the extent that the values of independent newspapers "are being artificially escalated by takeover bids from larger newspapers, consideration might be given to the remedies available under antitrust laws."

In conclusion, Halperin said the adoption of Udall's bill "would provide a wedge to be used again and again by other segments of society, each arguing its own importance."

The Treasury Department, he said, does "not believe in this piecemeal approach to legislation. There are existing provisions intended to minimize the problems inherent in the payment of taxes. If they are inadequate they should be reviewed in a comprehensive and not an ad hoc manner."

In his testimony before the subcommittee, Udall said the implications of the growing concentration of newspaper ownership in the United States are "onerous."

Insisting that he is not engaged in a battle against bigness of newspaper chains, Udall said that through his bill he hopes to "lessen the economic pressures on publishers who would otherwise be forced to sell their properties because of the present tax code."

There is the likelihood, Udall insisted, "that given the steady pace of acquisitions that there will be very few newspaper chains controlling virtually all American newspapers within 10 to 15 years."

With this growing concentration of ownership, he suggested, there also exists the potential "for abuse of the enormous power that these media conglomerates will hold."

Not all newspapers are bad, he told the subcommittee, "not all independent newspapers are good, but there is something vital to our communities that is threatened by the trend towards group ownership." And that, he suggested, "is an intangible element that goes with a locally owned and operated newspaper—a unique kind of community concern and responsibility that is not shared by a conglomerate motivated by profit alone."

K. Prescott Low, publisher of the independent Quincy (Mass.) Patriot Ledger and chairman of the American Newspapers Publishers Assn. tax law task force, submitted testimony for ANPA and the National Newspaper Assn.

The two associations, Low told the subcommittee, have not either endorsed or opposed the Udall bill. However, he said the associations "encourage the Congress to continue its analyses and deliberations. We are in the hope that prompt and proper solutions may be found, including ways to make the estate tax laws neutral on the question of the succession of closely held ownership."

The association, he said, are not convinced "that the approach set forth in H.R. 12395 is the sole or best one to pursue—either for the country in general or the newspaper business in particular."

Senator PACKWOOD. The next witness is Arthur Little, representing the National Association of Small Business Investment Companies. Go right ahead.

STATEMENT OF ARTHUR D. LITTLE, FIRST VICE PRESIDENT AND TREASURER, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES, ACCOMPANIED BY CHARLES NOONE

Mr. LITTLE. I am Arthur Little, president of Narragansett Capital Corp., a publicly owned small business investment company headquartered in Providence, R.I. I currently serve as first vice president and treasurer of NASBIC, the NASBIC industry trade association. NASBIC represents three-fourths of all the licensed SBIC's and MESBIC's, which in the aggregate account for approximately 90 percent of the industry's assets.

With me today is Charles Noone, general counsel of NASBIC.

I appear today in strong support of S. 3345, a bill to provide a deficiency dividend procedure for SBIC's qualifying in electing to be taxed as regulated investment companies under subchapter M of the IRS Code.

S. 3345 has the unanimous support of the Board of Governors of our Association, and we are hopeful that this subcommittee and full Senate committee will act promptly and favorably on this bill. SBIC's, as you know, are creatures of the Congress, licensed and regulated by the Small Business Administration pursuant to the Small Business

Investment Act of 1958. Simply stated, the function of an SBIC is to supply funds to smaller businesses and to make profits for its shareholders. The more advantageous it is to be an SBIC shareholder and have that shareholder benefit directly from the profits that an SBIC makes by investing in small businesses, the more money will be invested in the SBIC industry. Those funds will in turn flow into smaller businesses.

Passage of this bill will encourage more SBIC's like my own to become regulated investment companies that will pass through ordinary income they receive to their investors, thus creating a direct link between the SBIC investor and the SBIC portfolio company.

Heretofore, many companies have been hesitant to become regulated investment companies, because with no deficiency dividend procedure, the IRS, with its ever-present 20–20 hindsight, can and has claimed that regulated investment companies have missed the required 90 percent dividend payouts by tenths of 1 percent, thus subjecting their entire ordinary income to taxes. Except in cases of fraud it is unreasonable for the IRS to have power with such disastrous results. Virtually since the beginning of the program in 1958, publicly owned SBIC's have been concerned about the prospect of losing their dividends, paid deductions, through inadvertent miscalculation of their investment company income and other factors beyond their control.

Section 547 of the Code has for many years provided a deduction for deficiency dividends for personal holding companies where there is a determination that such a company has failed to pay out to its shareholders its personal holding company income. This procedure enables such companies to avoid a 70-percent tax imposed on undistributed personal holding company income.

Section 1601 of the Tax Reform Act of 1976 provides a similar deficiency dividend procedure for real estate investment trusts, commonly known as REITS. SBIC's registered under the 1940 act do not at present have the benefit of a deficiency dividend procedure. Such a procedure is critically necessary to the continued viability of the SBIC program.

Circulating the regulated investment company income of the SBIC's is frequently difficult, principally because of the unsettled state of the law relating to the bad debt reserves of such companies. For instance, IRS regulations state that reasonable additions to bad debt reserves are permissible for SBIC's but do not define the term reasonable. One dramatic current example involves a registered SBIC whose additions to bad debt reserves were disallowed by IRS on audit with the result that according to IRS, the SBIC failed by approximately $200 to pay out 90 percent of its regulated investment company income. IRS therefore disallowed the dividend paid deduction and is asserting a deficiency against the company for 1 year in the amount of $190,271.4.

If allowed to stand, the IRS's position would have an adverse effect on this particular SBIC and on the SBIC program generally. Investor confidence in publicly owned SBIC's would be damaged, reducing the ability of SBIC's to accomplish their congressional mission of supplying long-term loan funds and equity capital to eligible small business concerns.

My own company, Narragansett Capital Corp., is the largest publicly owned SBIC. We are in the process of becoming a regulated in-

vestment company during this current fiscal year. We are fearful, however, that the IRS might subsequently rule that we have not paid out 90 percent of our investment company income. Under current rules, we could not cure that deficiency. In our case, that could incur a $1 million tax liability on us or as little as a $1 error.

With a deficiency dividend procedure, we could make up the deficiency and not suffer a crushing blow.

Our Association feels that equity dictates the need for a deficiency dividend procedure for SBIC's to eliminate this problem and to put SBIC's on an equal footing with personal holding companies and REITS where adjustments by IRS or other factors beyond the control of the SBIC results in an inadvertent miscalculation with respect to their dividends.

I testified on June 14, before a subcommittee of the House Ways and Means Committee on H.R. 6877, a companion bill to S. 3345. I was pleased to learn at that time that the Treasury Department supported the deficiency dividend bill and recommended extending the proposed procedure to all regulated investment companies, not just SBIC's. We advised the House subcommittee at that time that we, of course, would not object to extending the deficiency dividend procedure to all regulated investment companies as recommended by the Treasury.

We respectfully urge this subcommittee to act promptly and favorably on S. 3345 and we thank you very much for this opportunity to be heard.

Senator PACKWOOD. Mr. Little, you are supporting an unusual bill, one that Treasury supports, if I read it correctly. Mr. Halperin, is that right? The Treasury has no objection to this bill.

Mr. HALPERIN. We do support the bill, Senator Packwood. We had recommended to the House a number of technical changes that would conform it to the procedures for the REIT's which I understand have been incorporated in the bill as reported out by the Ways and Means Committee, and I assume there are no objections to that.

Mr. LITTLE. That is correct.

Senator PACKWOOD. Let me compliment you, Mr. Little. Your statement is very clear in an area that is somewhat complex. It is a statement a layman can read and understand, and you make a good case.

Mr. LITTLE. Thank you.

Senator PACKWOOD. You're welcome, and thank you for your patience in waiting all morning.

Mr. LITTLE. Thank you.

[The prepared statement of Mr. Little follows:]

STATEMENT OF ARTHUR D. LITTLE, FIRST VICE PRESIDENT AND TREASURER, NATIONAL ASSOCIATION OF SMALL BUSINESS INVESTMENT COMPANIES

NATIONAL ASSOCIATION OF SMALL BUSINESS
INVESTMENT COMPANIES,
Washington, D.C.

Mr. Chairman and Members of the Subcommittee: I am Arthur D. Little, President of Narragansett Capital Corp., a publicly-owned small business investment company (SBIC) headquartered in Providence, Rhode Island. I currently serve as First Vice President and Treasurer of NASBIC, the SBIC industry trade association. NASBIC represents three-fourths of all licensed SBICs and MESBICs which, in the aggregate, account for approximately 90 percent of the industry's assets.

Accompanying me is Charles M. Noone, General Counsel of NASBIC.

I appear in support of S. 3345, a bill to provide a deficiency dividend procedure for SBICs qualifying and electing to be taxed as regulated investment companies under Subchapter M of the Code.

S. 3345 has the unanimous support of the Board of Governors of our Association, and we are hopeful that this Subcommittee and the full Senate Committee will act promptly and favorably on the bill.

SBICs are creatures of the Congress, licensed and regulated by the Small Business Administration pursuant to the Small Business Investment Act of 1958. Simply stated, the function of an SBIC is to supply funds to smaller businesses and to make profits for its shareholders. The more advantageous it is to be an SBIC shareholder and have that shareholder benefit directly from the profits that an SBIC makes by investing in small businesses, the more money will be invested in the SBIC industry. Those funds will in turn flow into smaller businesses. Passage of this bill will encourage more SBICs like my own, to become regulated investment companies that will pass through ordinary income they receive to their investors, thus creating a direct link between the SBIC investor and the SBIC portfolio company. Heretofore many companies have been hesitant to become regulated investment companies because with no deficiency dividend procedure, the IRS with its ever present 20-20 hindsight can and has claimed that regulated investment companies have missed the required 90 percent dividend pay out by tenths of a percent thus subjecting their entire ordinary income to taxes. Except in cases of fraud it is unreasonable for the IRS to have power with such disastrous results.

Since the first SBICs were licensed early in 1959, they have provided over $3 billion in financing to more than forty thousand small business concerns.

At the present time, there are two hundred seventy-two SBICs licensed and in operation. They have total assets slightly in excess of $1 billion, approximately one half of this being private capital and the balance being borrowed funds guaranteed by the Small Business Administration.

Of the two hundred seventy-two licensed SBICs, thirty-two are currently registered under the Investment Company Act of 1940 as publicly-owned companies. These thirty-two companies account in the aggregate for approximately one-third of all industry assets.

Of the thirty-two companies registered under the 1940 Act, twenty-one qualify and elect to be taxed as regulated investment companies. The performance of these publicly-owned SBICs constitute a bellwether of the industry. Their performance influences investors who have the potential of putting additional private capital into the SBIC industry by investing in existing companies or forming new ones.

Virtually since the beginning of the program in 1958, publicly-owned SBICs have been concerned about the prospect of losing their dividends paid deduction through inadvertent miscalculation of their investment company income and other factors beyond their control.

Section 547 of the Code has for many years provided a deduction for deficiency dividends for personal holding companies where there is a determination that such a company has failed to pay out to its shareholders its personal holding company income. This procedure enables such companies to avoid the seventy percent tax imposed on undistributed personal holding company income.

Section 1601 of the Tax Reform Act of 1976 provides a similar deficiency dividend procedure for real estate investment trusts (REITS).

SBICs registered under the 1940 Act do not, at present, have the benefit of a deficiency dividend procedure. Such a procedure is critically necessary to the continued viability of the SBIC program.

Calculating the "regulated investment company income" of SBICs is frequently difficult, principally because of the unsettled state of the law relating to the bad debt reserves of such companies. For instance IRS regulations state that "reasonable" additions to bad debt reserves are permissible for SBICs but do not define "reasonable."

One dramatic current example involves a registered SBIC whose additions to bad debt reserves were disallowed by IRS on audit with the result that, according to IRS, the SBIC failed by approximately $200.00 to pay out 90% of its "regulated investment company income" to its shareholders. IRS therefore disallowed the dividend paid deduction and is asserting a deficiency against the company for one year in the amount of $190,271.54.

If allowed to stand, the IRS position would have an adverse effect on this particular SBIC and on the SBIC program generally. Investor confidence in publicly-owned SBICs would be damaged, reducing the ability of SBICs to accomplish their congressional mission of supplying long-term loan funds and equity capital to eligible small business concerns.

My own company, Narragansett Capital Corporation, is the largest publicly-owned SBIC. We intend to become a regulated investment company this fiscal year. We are fearful however, that the IRS might subsequently rule that we had not paid out 90% of our investment company income. Under current rules we could not cure that deficiency. In our case that could incur a $1 million tax liability for as little as a $1.00 error. With a deficiency dividend procedure we could make up the deficiency and not suffer a crushing blow.

Our Association feels that equity dictates the need for a deficiency dividend procedure for SBICs to eliminate this problem and to put SBICs on an equal footing with personal holding companies and real estate investment trusts where adjustments by IRS or other factors beyond the control of SBICs result in inadvertent miscalculations with respect to their dividends.

I testified on June 14 before a subcommittee of the House Ways and Means Committee on H.R. 6877, a companion bill to S. 3345. I was pleased to learn at that time that the Treasury Department supported the deficiency dividend bill and recommended extending the proposed procedure to all regulated investment companies, not just SBICs. We advised the House subcommittee at that time that we of course would not object to extending the deficiency dividend procedure to all regulated investment companies as recommended by Treasury.

We respectfully urge this Subcommittee to act promptly and favorably on S. 3345.

We thank you for this opportunity to be heard.

Senator PACKWOOD. We adjourn the hearing for the day.

[Whereupon, at 11:45 a.m., the subcommittee was adjourned.]

[By direction of the chairman the following communications were made a part of the record:]

STATEMENT BY SENATOR PAUL LAXALT

Mr. Chairman: I am delighted that you have seen fit to hold hearings on my bill, S. 3176 to clarify the federal tax treatment of so-called "Contributions-in-aid-of-Construction". I think it is an important bill, and I urge its prompt consideration by the full Committee.

In 1975, the Internal Revenue Service issued Revenue Ruling 75-557, which held that connection fees received by a public utility are includable in the utility's gross income and are taxable. Before that ruling, whenever an individual or company applied to a utility for service and paid the utility to help defray the cost of construction to build the lines out to the new customer, the money paid was considered a contribution to capital. The utility paid no taxes on this contribution and the contributions were not included in the rate base.

Under 75-557, any time a payment is made to a utility, whether to assist in establishing a new service or to relocate an old one, that payment must be included in taxable gross income. As a result, utility companies have applied for a 92.3 percent increase in the amount they charge for new connections to cover the cost of actual construction and the 48 percent corporate tax rate applied to these funds.

New customers, particularly for homes are especially hurt by this ruling. The cost of connection fees in Nevada has nearly doubled. For example, the U.S. Navy requested the Sierra Pacific Power Company to extend service to serve a microwave station in San Bruno, California. The cost of the extension was estimated at $175,000, but, under the terms of 75-557, Sierra Pacific was forced to request $337,000. The Southern Pacific Industrial Development Company in 1977 decided to build an industrial park in Sparks. Because of 75-557, the cost of utilities to serve this development will be increased from $1.2 million to $2,307,600—from $2.439 to $4.690 per acre. In short, 75-557 discourages capital formulation and increases the cost of new building at a time of increasing costs and sluggish growth.

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My bill, S. 3176, will largely restore the tax code to what it was prior to the issuance of the Ruling by amending Section 118 of the Internal Revenue Code to confirm the long standing rule that contributions in aid of construction and amounts similarly treated, termed governmental relocation reimbursements, do not constitute gross income to regulated gas and electric utilities.

The tax treatment of such contributions as income was expressly negated by the Tax Reform Act of 1976, but only for water and sewage disposal public utilities.

The purpose of my bill is simply to provide the same treatment for gas and electric utilities, and thereby codify and confirm the historical treatment of these amounts as non-taxable. Because these utilities traditionally have not been including these contributions in gross income, my proposal would not create a revenue loss to the U.S. Treasury.

During its consideration of the Tax Reform Act of 1976, the Finance Committee voted on May 20, 1976 to repeal IRS 75–557, but later backed off and repealed the ruling only for water and sewage utilities. On the Senate floor, Senator Curtis tried to amend the bill to also exclude electric and gas utilities. Speaking for Senator Long, Subcommittee Chairman Byrd said, "Probably it is an area that should be considered by Congress sometime, but at the present time, there appears to be inadequate information as to the need for the amendment proposed by the Senator from Nebraska and also inadequate facts as to just what the contributions-in-aid would cover."

The Curtis Amendment was subsequently defeated 40–47.

Mr. Chairman, as I see it, failure to enact this bill could have serious adverse impacts. If tax liability is successfully imposed by the IRS on gas and electric utilities, utility rates will have to be increased, thereby forcing all utility users to effectively subsidize new projects. However, if the liability is not recovered through a general rate increase by the utility, the contribution amount in most cases will have to be approximately doubled to pay the tax liability on the contribution and still complete the construction work. This is also not acceptable, because it would lead to increases in the front-end costs of builders to assure utility service for new housing, and make it increasingly difficult for the average American family to afford a new home.

Mr. Chairman, I urge prompt Committee consideration of S. 3176.

Statement of Senator Charles McC. Mathias, Jr.

I am pleased to be able to participate in the Subcommittee's debate on the important issue of product liability insurance.

As I am sure the Subcommittee is aware, Senator Bayh and I introduced a product liability bill, S. 2864 last spring. The bill is similar to H.R. 7711, which Congressman Whalen introduced in the House.

The bill addresses both the problems that many companies run into when they try to get liability insurance, and the problems encountered by professionals such as doctors, lawyers, architects, and engineers who try to protect themselves by buying such insurance. Our bill would allow business owners and professionals to pay into a trust fund to cover their risks, and then deduct those payments from income as a normal cost of doing business, just as they now can with insurance premiums. In other words, the bill allows them to self-insure.

In early April of this year, the Department of Commerce published the findings of its 2-year task force that studied the growing problems of product liability. The Department of Commerce proposed a liability insurance plan in many ways similar to our bill, and virtually identical to Senator Culver's bills, S. 1611 and S. 3049. Another study was undertaken by Congressman Whalen which revealed that of those companies that want to obtain product liability insurance coverage, approximately one out of five said that they either cannot afford it or cannot find an insurance carrier willing to sell it to them. The study also found that the increase in product liability costs, for those who were able to obtain coverage, was 944 percent in the period since 1970. The increase in sales volume for companies for the same period was 162 percent. Hence, premiums grew at a rate 5.8 times greater than sales. Clearly, this indicates that something must be done, and quickly.

Congressman Whalen presented his study last year to the House Small Business Committee. He concluded that one out of every three companies surveyed said it has been forced to increase the price it charged for at least one product

line as a direct consequence of increased product liability premiums. His study demonstrated that one out of every six firms surveyed had been forced to abandon at least one product line as a direct result of product liability insurance problems.

Many business owners and professionals who have not been able to obtain product liability insurance coverage want to establish such self insurance reserve funds. And those with policies with high deductibles also want to establish reserve funds to cover the cost of the deductible portion of the policy. These deductibles sometimes run into hundreds of thousands of dollars.

The federal tax laws affect these self-insurance funds in two ways. First, a business expense deduction is not available to the company that pays into its own reserve fund. A comparable payment as an insurance premium would entitle the company to a deduction in that amount. Second, as the self-insurance reserve fund builds up, the interest it earns is taxed, and the fund becomes vulnerable as an "unreasonable" accumulation of capital.

The large firms establish captive insurance companies. Others deal with expensive outside insurance companies. These options, however, are closed to many small companies and individuals.

Our bill addresses these problems in two ways. First, it exempts from federal income tax interest earned on those funds placed in a self-insurance trust fund. Second, the money paid into the fund can be deducted as a cost of doing business, as an insurance premium can be.

These trust funds may be established by groups as well as single persons. Thus, law firms or trade associations would be able to create self-insurance pools for their members with fewer tax complications than are now encountered. The bill also establishes guidelines for limits on how much money can be placed in the trust. Furthermore, it restricts the use of money placed in the eligible reserve funds, making the money taxable as income if it is withdrawn or used for any other purpose.

The bill puts people who self-insure on the same footing as those who purchase from name carriers. It gives them no special benefits.

A constituent of mine from Frederick, Maryland, who manufactures industrial and construction equipment, voiced his support quite clearly:

"I'm sick and tired of being ripped off on insurance premiums. I believe that here is a way to cut these costs, or in some cases even eliminate them."

Senator Culver's bills, S. 1611 and S. 3049, are similar to S. 2864 in two ways: first, they allow businesses to insure themselves against product liability suits by means of a reserve; and second, they allow for a deduction for money paid into the reserve. His bills represent an important step in the right direction. In the course of committee consideration, however, I hope they will be extended to allow for the full coverage of S. 2864.

I want to stress the importance of extending the benefits of this concept to professionals. They all are finding it more and more difficult to purchase liability insurance for themselves. A study by the Rand Corporation showed that between 19 and 25 percent of the physicians practicing in Southern California in 1976 had no commercial insurance coverage. The best estimate available was that between 10 and 15 percent of all doctors in the country were practicing without any insurance.

As the Subcommittee already knows, the President has also proposed product liability legislation. He proposes a tax carry-over approach, a far less satisfactory one from a business point of view, but especially to the small business owner. Under his plan, the owner would be able to get credit on taxes owed for all payments made to cover liabilities. Frankly, I am much heartened by the fact that the President has made a counter offer. It shows that we've got him thinking about the problem. We have a great deal of support for our position from many small businesses and professional groups, and I hope that our bill, or a variation of Senator Culver's, will prevail over the President's alternative.

Mr. Chairman, the time has come to eliminate this inequity in the tax laws. In our increasingly complex society, it is more and more often the case that disputes must be resolved by litigation. We must protect businesses and professionals from the damaging and possibly destructive liability suits they may from time to time encounter.

In the end we all suffer if they are forced to curtail their activity or even go out of business because of their inability to get adequate protection for themselves and their families.

I urge the Subcommittee to act favorably on the proposed legislation.

TESTIMONY OF SENATOR GAYLORD NELSON, CHAIRMAN, SENATE SMALL BUSINESS COMMITTEE

Mr. Chairman, I appreciate the opportunity to inform the Subcommittee of my support of S. 3345, a bill to permit Small Business Investment Companies to be covered by the "deficiency dividend" procedure presently in the Internal Revenue Code. The bill is non-controversial. It is favored by industry, the Treasury Department, and the Congressional committees which have considered it. I would hope that the bill will be speedily approved in the Senate and enacted during 1978.

PURPOSE OF THE LEGISLATION

S. 3345 would extend the "deficiency dividend" procedure, now available in the Internal Revenue Code to personal holding companies and REIT's, to SBIC's established under the Small Business Investment Act of 1958. As you know, all of these companies exist primarily to collect income for transmission to their owners and shareholders. Accordingly, no tax is imposed at the corporate level for all of these companies as long as they pay out at least 90% of their income.

If a small accounting error, miscalculation, or dispute with the Internal Revenue Service results eventually in less than 90% actually being paid out, personal holding companies and REIT's can, at that point, declare a "deficiency dividend" retroactively, to reach the required 90%. This relief provision has not yet been extended to SBIC's, which operate in the same way. It is only equitable that this be done.

EFFECTS OF THE BILL

The bill will have consequences at four levels:

First, there is one SBIC which, as a result of an adverse ruling by the Internal Revenue Service, missed paying out what it considered to be far more than 90% of its income by the total sum of $243.22. This company happened to be the first established in the industry, and has had a flawless regulatory record until this time. There is no question of the good faith of the company in attempting to meet the 90% pay-out standard.

The intent of the bill is to apply retroactively, so that the company in question can pay whatever "deficiency dividend" is now judged to be adequate by the IRS. This would prevent a tax deficiency of $190,271.54 currently demanded by the IRS as corporate level taxes.

There are further details of this case in the attached statement of July 26. There has been no objection voiced to this relief aspect of the legislation and, in fact, there is general agreement to extract such a penalty tax would be completely unfair in this situation.

Second, this legislation would apply to the 32 SBIC companies which are publicly-owned by stockholders, and which are subject to similar IRS actions at some future time.

Third, beyond this group, we have 250 additional SBIC's, some of which are actively considering becoming public companies. That entails the soliciting of additional capital from new stockholders in order to render greater financial assistance to smaller business. If the situation is clarified, we can thus undoubtedly expect a greater volume of investment activity and infusion of capital into these companies.

Fourth, there has been, among the investment community not presently participating in the SBIC program, an increased level of interest. Some of this interest results from legislation being considered by the Senate Small Business Committee to strenghten the SBIC program (Title IV of H.R. 11445). There is also increasing recognition of the profitability of new enterprises that accompany industrial innovation, new employment, economic growth, increased exports, and community stability where these ventures put down their roots.

President Carter has just directed all of the agencies of the Federal government to perform a thorough review of policies than can be used to promote innovation. Our joint hearings with the House Small Business Committee of August 9 and 10 established on the basis of a series of studies that the small businesses and individual inventors consistently account for more than half of all new business innovations, a record which has been labeled "striking" by the President's own Office of Management and Budget.

Interest in SBIC investment activity has been inhibited by not only direct threat of exposure to th nIternal Revenue Service without the "deficiency dividend" procedure, but the indirect implications of an unjust treatment of this

investment medium by government laws and regulations. If this injustice can be removed, it will spur activity all up and down the line.

TECHNICAL ASPECTS OF THE BILL

This proposal was originally made in 1976 (as Amendment No. 2077) in connection with the Tax Reform Act of that year. A more detailed history is included in my remarks of July 26, 1978 upon the introduction of S. 3345, and I would ask that this statement be included in the record of this hearing for background purposes.

To bring this history up-to-date, the House bill embodying this proposal (H.R. 6877) was ordered reported by the full Ways and Means Committee of the House on August 15, 1978, with the formal report expected to be filed shortly. Thus, both the House Subcommittee on Miscellaneous Revenue Measures, and the full Ways and Means Committee have approved the measure.

The Treasury Department formally approved and supported the bill and went beyond it to suggest that the same procedure be extended to all mutual funds registered under the investment Act of 1940.

We understand that there is no objection by any element of industry or of the regulatory bodies concerned to including this Treasury suggestion in the Senate bill. We would suggest this as a sound procedure to avoid the necessity for a conference.

In this regard, there is another technical area where the Senate legislation should be conformed to the House bill.

The Senate bill would add separate sections to the Code, while the House bill would insert the applicable SBIC language in Sections 856 through 860 of the Internal Revenue Code which presently make provision of REIT's. We would recommend this also be done in the Senate bill.

The House also considered requiring a percent of pay-out higher than 90 percent, but reported the 90 percent figure which is now in S. 3345, so that no change is necessary in this respect.

IMPORTANCE OF THE SBIC INDUSTRY

The so-called "venture capital industry", of which SBIC's are a central part, are a vital link in providing the risk capital and specialized advice which nurture companies from their founding through the various stages of their growth to the time they have the product and financial strength to offer their stock for sale and ask the public to participate as stockholders. This may take up to 10 years to intensive effort by the new, young ventures, however promising they may be. SBIC's, which offer development expertise in particular industries as well as in financing, are invaluable in resolving the many problems along the way.

In less than 20 years, the 282 SBIC's have accumulated about $1 billion in assets and have made about $3 billion in investments and loans over this period to over 40,000 such companies.

That is remarkable record, and it deserves to be encouraged for the benefits of small business and the national economy.

SUMMARY

Mr. Chairman, the facts, the equities, and sound public policy fully support the adoption of this non-controversial bill. I hope that the Subcommittee and full Committee will be able to act expeditiously on this measure so that it can be enacted into law during this year.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., August 23, 1978.

Senator HARRY F. BYRD, Jr.
Chairman, Subcommittee on Taxation and Debt Management Generally, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

Dear Mr. Chairman: It has come to our attention that on Monday, August 28, the Finance Subcommittee on Taxation and Debt Management Generally will likely hear testimony and consider legislation introduced by Senator William Hathaway, S. 2771. This measure seeks to prohibit the taxation of bingo games operated by tax-exempt organizations as an "unrelated trade or business."

Similar legislation has been under consideration by the House Ways and Means Committee, and on August 17 the Subcommittee on Miscellaneous Revenue Measures favorably reported legislation to the full Committee. As sponsors of this effort to clarify the intent of Congress with regard to the taxation of bingo games by tax-exempt organizations, we respectfully request your thoughtful attention to this issue and favorable consideration of legislation to remedy the present situation.

Sincerely,

WILLIAM M. BRODHEAD, M.C.
BOB TRAXLER, M.C.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., July 13, 1978.

Hon. JOE D. WAGGONNER, Jr.,
Chairman, Subcommittee on Miscellaneous Revenue Measures, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

DEAR JOE: As you know from our recent conversation, a recent Eighth Circuit Court of Appeals decision could result in thousands of dollars in back tax liabilities for charitable and non-profit organizations across the country. We need to act swiftly to protect groups like the VFW, Jaycees, Rotary, Lions Clubs, Knights of Columbus, YWCA, American Legion, Elks, senior citizen groups, and other non-profit charitable and civic organizations who operate licensed weekly bingos to raise funds. The organizations now find themselves in possible tax jeopardy.

Internal Revenue Service interpretations and recent court rulings have classified bingos, held regularly by non-profit groups using paid workers, as an "unrelated trade or business" that is subject to the federal income tax. However, because the law was not previously clear on this issue, most non-profit organizations have not paid taxes and could be liable for thousands of dollars in back taxes.

I do not believe that bingos run by a charitable organization should be taxed. The many states that permit bingos have done so *only* to help assist non-profit groups to raise money for their charitable and civic purposes.

Congress has exempted most income of these groups from taxation in order to further their legitimate charitable, educational, social, and civic purposes. Tax exemptions serve a valid public purpose in this case. We tax income from "unrelated trade or business" *only* because tax exemption for a "commercial" operation would give the non-profit "business" an unfair advantage in competing with regular businesses. In this case, there are no regular commercial bingos with which to compete. There exists no possibility of "unfair competition," and therefore, no valid public policy purpose is served in taxing these bingos. (The federal revenues involved are minimal.)

I have introduced a bill which simply states that income from bingos does not constitute income from an "unrelated trade or business" under the Internal Revenue Code. It is my hope that this bill will be referred to your Subcommittee, and that you will act expeditiously and favorably to protect the hundreds of veteran, social and civil organizations across the country who need our help.

With warm personal regards, I remain

Sincerely,

BOB TRAXLER,
Member of Congress

Enclosures.

BACKGROUND INFORMATION ON H.R. 13405

SUMMARY OF THE BILL

This bill amends the Internal Revenue Code (IRC) to treat the conducting of bingos by tax-exempt organizations as NOT being an "unrelated trade or business", thereby exempting the income from such games from the federal income tax.

BACKGROUND

Current tax status of Nonprofit charitable organizations

In general, the IRC exempts from the federal income tax most kinds of income received by qualified "non-profit" organizations. Sec. 501 provides the tax exemption and defines which organizations qualify.

Social and civic groups have been granted a tax-exempt status by Congress and the states to further a specific public policy purpose—namely, to promote the educational, cultural and civic goals of these kinds of organizations.

One kind of income received by such groups, however, has been classified as subject to the income tax. Income from an "unrelated trade or business"—as defined by Sec. 511–513 of the IRC—is taxed at the regular corporate rate.

An "unrelated trade or business" is generally defined in the Code, regulations, and court rulings, as a regularly operated business, with paid workers, where the conduct of such trade or business is not substantially related (other than raising funds) to the organizations performance of its exempt functions.

Such activities were made taxable so that a non-profit group could not compete unfairly with a regular commercial enterprise because of lower overhead costs resulting from a tax-exempt status. The legislation history is clear: these activities are taxed only to put a non-profit group on an equal basis with competing commercial enterprises of a similar type. There is no other public policy purpose served in taxing these non-profit groups.

The dissenting opinion in Clarence LaBelle Post No. 217, VFW, v. United States Government gives an excellent summary of the legislative history concerning this issue. A copy of this opinion is attached.

As an example, a local VFW chapter would be exempt from taxes on income derived from direct donations, a fund-raising barbeque, or a garage sale. However, if the same chapter bought and operated a gas station, and paid its employees, the profits would be taxable. (If they were not taxable, the gas station could presumably sell gasoline at several cents a gallon less than competing gas stations, and this would be unfair competition.)

Tax status of bingo games

States permit non-profit groups to operate regular bingos as a means of fund-raising.

The legal issue for some time now has been: Is a regularly operated bingo a "fund-raising event" or is it an "unrelated trade or business?" The IRS apparently believes it is to be the latter, but until the most recent Court of Appeals decision, the issue was not made clear.

Most non-profit groups run weekly bingos and many pay their workers a nominal sum. For example, the State of Michigan bingo law permits bingo workers to be paid up to $8 per night.

It appears that the Court of Appeals ruling (Clarence LaBelle Post No. 217, VFW, v. U.S.) would subject all such bingos, operated by churches, non-profit organizations, and political organizations on a regular basis, using paid workers, to the federal income tax.

It is my understanding that, because the law was previously unclear in this area, many such organizations have not paid taxes in the past, nor have they set aside past earnings that could be used to pay back taxes.

Thus, if the designation of bingos as an "unrelated trade or business" by the Court is not set aside, these non-profit charitable and civic groups across the country may find themselves liable for thousands of dollars in back taxes.

Tax treatment of political organizations

Several states classify political party organizations as non-profit groups eligible for bingo licenses. Although taxed in a separate part of the IRC as the Sec. 501 groups, the tax situation for political organizations is precisely the same: most income is tax-exempt except for that derived from an "unrelated trade or business."

H.R. 13405

This bill simply amends two sections of the IRC to clarify the intent of Congress that *non-commercial* bingos that do not violate state law are not considered an "unrelated trade or business."

[COMMITTEE PRINT]

DESCRIPTION OF TECHNICAL AND MINOR BILLS LISTED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON MISCELLANEOUS REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

ON

AUGUST 11, 1978

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

AUGUST 10, 1978

U.S. GOVERNMENT PRINTING OFFICE
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III. DESCRIPTION OF BILLS

1. H.R. 8533 (Also H.R. 7460 and H.R. 13405)

Exemption for Income Received by Certain Tax-Exempt Organizations From Bingo and Similar Games

Present law

Under present law, most organizations which are generally treated as tax-exempt under the Internal Revenue Code are nonetheless subject to tax on their unrelated business taxable income (sec. 511). Thus, unless a specific exception applies, an organization which is tax-exempt (under sec. 501(a))[1] is subject to tax with respect to income derived from any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds) to the exercise or performance of its exempt function.

Under some State laws, nonprofit organizations are allowed to conduct bingo games or other similar types of games to raise funds for their exempt purposes. Often State laws limit the conduct of these types of games to nonprofit organizations.

Two recent cases have held that tax-exempt organizations are subject to unrelated business income tax on the proceeds of bingo games regularly carried on by the organizations with paid labor even though the organizations were not in competition with for-profit businesses.[2]

For political organizations, "exempt function income" is tax exempt, but all other income is subject to tax. Exempt function income means (1) contributions, (2) membership dues, fees, and assessments, and (3) proceeds from a political fund-raising or entertainment event, or the proceeds from the sale of political campaign materials, which are not received in the ordinary course of any trade or business (sec. 527).

Thus, for political organizations, the proceeds of bingo or similar games which are regularly carried on with paid labor do not qualify as "proceeds from a political fund-raising or entertainment event, which are not received in the ordinary course of any trade or business," and, consequently, these proceeds would be subject to tax.

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[1] In this pamphlet, references to "exempt organizations" do not include social clubs (sec. 501(c)(7)) and employees' beneficiary associations (sec. 501(c)(9)), which may be taxable on investment income of all types as well as unrelated business income. The term "exempt organizations," as used also does not include political organizations (as described in sec. 527) and homeowners' associations (as described in sec. 528).

[2] *Clarence LaBelle Post No. 217 v. United States* —— F. 2d —— (8th Cir. 1978), 78-1 USTC ¶9496; *Smith-Dodd Businessman's Ass'n*, 65 T.C. 620 (1975). In the *Smith-Dodd* case, a specific exemption for trades or businesses in which substantially all the work is performed without compensation (sec. 513(a)(1)) was held to be inapplicable because the organizations paid the workers $2 per hour and these sums could not be specifically correlated with the workers expenses. (The court indicated that expense reimbursement of workers might not violate the "without compensation" requirement.)

8

Issue

The primary issue is whether tax-exempt organizations and political organizations should be subject to taxation on income from bingo and similar games that are conducted in accordance with State and local law and not in competition with profit-making businesses even though such games are regularly carried on with paid labor.

Description of the bills

H.R. 7460

H.R. 7460 would exempt from taxation the proceeds of bingo and similar types of games in situations where State or local law permits such activities to be carried on by nonprofit organizations. This exemption from taxation would apply even though the activity is regularly carried on and is carried on with paid workers. However, to qualify for this exemption from the unrelated business income tax, the activity must not ordinarily be conducted on a commercial basis in the State in which the organization operates, and the conduct of the activity must not violate State or local law.

This bill would apply to games of the type in which usually the wagers are placed, the winners are determined, and the prizes are distributed in the presence of all persons placing wagers in the game. Thus, this bill would generally apply to bingo games, keno games, card games, dice games, and games involving wheels of chance, such as roulette wheels. (The statutory definition follows one of the exclusions from the term "lottery" under the wagering tax (sec. 4421(2)(A) of the Code).)

H.R. 8533

H.R. 8533 would provide that the exempt function income (i.e., tax-exempt income) of a political organization would include income from bingo and similar games that are conducted in accordance with State and local law and not in competition with profit-making businesses, even though such games are regularly carried on with paid labor. The types of games that could be conducted on a tax-free basis are defined in the same manner as the games that could be conducted on a tax-free basis by other exempt organizations under H.R. 7460.

H.R. 13405

H.R. 13405 would provide the same exemption for tax-exempt organizations from unrelated business income tax for income from bingo and similar games as would H.R. 7460. In addition, H.R. 13405 would provide the same exemption from tax for political organizations with respect to income from bingo and similar games as H.R. 8533.

Effective date

H.R. 7460 would apply to taxable years beginning after December 31, 1969. H.R. 8533 would apply to taxable years beginning after December 31, 1974 (the effective date of sec. 527 of the Code, which provides rules for the taxation of political organizations). The provisions of H.R. 13405 relating to section 501(a) organizations would apply to taxable years beginning after December 31, 1969; and the provisions of the bill relating to political organizations would apply to taxable years beginning after December 31, 1974.

Treasury position

The Treasury supports these bills only on a prospective basis and only for bingo where it is conducted in accordance with State and local law and, pursuant to such law, may not be conducted by profit-making businesses.

NOTE: Treasury has since revised their position so as not to oppose retroactivity back to December 31, 1974.

ACTIONS TAKEN BY SUBCOMMITTEE ON MISCELLANEOUS REVENUE MEASURES

On a motion by Mr. Frenzel, H.R. 13405 was amended to include the Treasury recommendation that "qualified games" be limited to bingo.

On a further motion by Mr. Frenzel, the text of H.R. 8533 was substituted by the text of H.R. 13405, as amended, and H.R. 8533, as amended, was reported to the full Committee on Ways and Means.

STATEMENT OF THE ALLIANCE OF AMERICAN INSURERS, DONALD L. JORDAN, ASSISTANT VICE PRESIDENT

The Alliance of American Insurers is a major national trade association representing over 100 insurance carriers which write property and casualty insurance coverages for commercial and personal insurance accounts in all fifty states and the District of Columbia.

The Alliance has maintained an ongoing special interest in product liability insurance matters over the past several years both in Washington and at the state level. We have worked closely with the Inter-Agency Task Force on Product Liability as well as the National Association of Insurance Commissioners and the Insurance Services Office in developing necessary information to place the magnitude of product liability problems in proper perspective, develop a realistic understanding of causes and evaluate workable solutions. We believe the Alliance is, therefore, in a strong position to provide useful information to the Subcommittee in their evaluation of alternative tax proposals to help fund product liability losses. In order to place these tax proposals in proper perspective, we first briefly review the magnitude of the products problem and the need to address its causes rather than its affects.

We recognize that there have been problems with the affordability of product liability insurance particularly for smaller businesses. We are convinced, however, that these problems have been limited to date both in terms of their impact on our overall domestic economy and on the number of business firms who have actually experienced significant financial dislocation or major insurance placement and affordability problems. Various exhaustive studies including those conducted by the Inter-Agency Task Force on Product Liability under the direction of the Commerce Department have indicated, for example, that the total cost of product liability insurance for the great majority of business firms is less than 1% of gross sales. In addition, there has been extensive evidence uncovered that those insurance problems which do exist are related principally to affordability problems have been uncovered only in certain limited product sectors i.e., those firms manufacturing, distributing or installing certain types of industrial products that require careful handling or are potentially dangerous to workers as well as a limited number of consumer products.

The Alliance is convinced that the best approach to those product liability insurance affordability problems that do exist is to address their fundamental causes. It must therefore be recognized at the outset that proposals for tax deductible self-insured trusts do not address the fundamental causes of the product liability problem which are (1) our existing tort system which has fueled the ever-increasing cost and severity of product liability claims; (2) the existence of dangerous and potentially hazardous products; and (3) a social compensation philosophy that increasingly focuses on entitlement rather than product defect or manufacturing negligence.

Proposals which are restricted to creating new methods of funding existing losses will have no impact on reducing product liability losses but will simply lead to the reallocation of existing loss costs. Such tax proposals do not treat the cause of the problem, only the timing of its financial impact on business concerns. Essentially, making product liability loss reserves tax deductible simply establishes a somewhat arbitrary expense (i.e. 3% of gross sales) and a restricted asset account (The Trust) to fund potential losses in the future. Hence, over a period of time the total of all loss costs that must be funded will not be lessened by the tax proposal but will have remained essentially unchanged.

There is a related problem in the use of self-insured reserve trusts particularly for small businesses to fund their product liability loss exposures. Self-insurance when it has been used in the past is invariably adopted when two conditions prevail. First, claim frequency is the principal problem rather than claim severity:

Secondly, losses are somewhat predictable. that is, loss experience can be estimated actuarily with some degree of accuracy. Just the opposite condition prevails, however, with respect to the product liability loss exposures for small companies. This is so because claim severity is the major concern rather than claim frequency, while liabilities and claim filings are highly unpredictable and irregular in their occurrence. Placing $25,000 a year in a self-insured reserve trust does little to help a business faced with the potential of a million dollar product liability claim (not an unknown occurrence) nor does it provide sufficient protection for the potential plaintiff who suffers a loss.

We are satisfied that the tax treatment of product liability self-insured trusts is a subject that has received a most thorough-going review by this Administration, both by the Commerce Department in its various studies through the Inter-Agency Task Force on Product Liability and by the Treasury Department in its specific follow-up study of tax proposals to deal with product liability loss reserves. We therefore wish to call attention to the Statement by Secretary Juanita Kreps (who initially supported a tax set aside proposal) that the tax carryback alternative may result in a "better use of capital" since funds would not be required to be maintained in a segregated low yield fund. The Treasury Department has also concluded that a tax loss carryback would be far more efficient, more equitable and certainly simpler to administer than a product liability self-insured trust which in itself would not conform to existing tax law.

Under present tax Regulations two essential conditions must be met for self-insured reserves to be deductible. First. the actual liability must be fixed, and second. the magnitude or amount of liability must be determined with reasonable accuracy. (Treasury Regulation 1.461-(a)(2)), the "all events test"). Under the "all events test" a deduction is not allowed for reserves for anticipated product liability losses if the loss has not yet occurred prior to the close of the taxable year. This position regarding the deductibility of contingent loss reserves is also consistent wtih that adopted by the Financial Accounting Standards Board (FASB) in their Statement No. 5 (Before a loss contingency may be recognized, available information must indicate that: a) an asset has been impaired or a liability incurred and b) the amount of loss must be reasonably estimated). A contingency self-insurance reserve meets neither of these tests.

CAPTIVE INSURERS

A brief comment is necessary on tax proposals that would enable domestic captive insurance companies to deduct contributions for product liability losses. The Alliance believes that this proposal might benefit only a select number of smaller businesses who could conceivably combine their product liability exposures through an association owned captive insurance company. As currently drafted S. 3049 requires that a qualified product liability captive must be created or organized *in the United States* for the exclusive puropse of paying product liability losses and related expenses sustained by the tax payer. This means a United States based captive insurer. To date only about 3 dozen or so captive insurance companies have been organized domestically principally in Colorado although a few other states are preparing legislation which would track closely with the existing Colorado captive law. To establish a Colorado captive, however, *requires a minimum of one million dollars of capital and surplus up front with other significant additional costs* (i.e., management fees would run many thousands more to enable the captive to operate in conformance to state insurance regulations).

What small company on its own would have the financial resources to tie up in excess of one million dollars of existing working capital in low yielding government securities (or other regulated high liquidity low yield "safe" investments) to establish a domestic captive solely for the purpose of funding product liability loss reserves?

Would a self-insured trust limited to funding product liability loss contingencies really be used by small business?

To answer this question, we refer to a recent study by the National Federation of Independent Businesses who surveyed their membership using a selected sample of 4.214 of their some 31,000 members. The NFIB found that 42.8% of respondents reported that they could not establish a self-insured trust fund and that another 24.8% stated they could do so, but only with difficulty. Finally, only 5.9% of all firms responding to the NFIB survey said that such a fund was readi-

ly possible. The NFIB report went on to say these results should not surprise anyone as establishment of such a non-productive trust fund would exacerbate existing serious capital problems for many small firms.

CONCLUSION

We believe that a self-insured product liability trust fund is at best a short-term approach that is not a substitute for essential longer-term solutions such as modification in state tort laws and other efforts to deal with the root causes of the product liability problem. Secondly, it is an approach which has very limited application to only a small number of businesses who could benefit by its passage. Finally, we cite the position of the Administration including the Commerce and Treasury Department which believe that a tax loss carry back would be a preferable interim approach to dealing with product liability insurance affordability problems that do exist.

STATEMENT OF THE AMERICAN INSTITUTE OF ARCHITECTS

This statement is in support of S. 2864 and H.R. 7711 which are similar to the bills that were the subject of committee hearings. We strongly urge the inclusion of design professionals within the coverage of the legislation you have under consideration. The liability problems of product manufacturers have justifiably become a matter of Congressional concern, and we are convinced that an examination of the facts will show the liability problems of design professionals warrant equal attention. Every product and every building or structure created must first be designed. In the product field, this is often done by the manufacturer's personnel. In the area of buildings and structures, however, the design is usually done by independent professional design firms. And just as product manufacturers have experienced stunning increases in the cost of liability coverage, so too has this group of design professionals.

THE PROBLEM

During the 1960's, professional liability insurance for building designers generally cost less than one per cent of a firm's gross receipts. Because of it's manageable cost and ready availability, purhased insurance became widely accepted by architects, engineers (A-E's) and their clients. In the 1970's, however, insurance premiums for this coverage began to skyrocket, with annual increases of 100% or more not uncommon. Actual increases, of course, vary by firm and state, but nationally, the average annual premium increases have raised raised the cost of insurance 577% over the past eight years. Liability coverage now represents an average of 3 to 10% of a design firm's gross receipts. For many A-E's, insurance coverage is now the largest single cost item after payroll. What is more, purchased insurance is generally a fixed cost for construction designers, while the construction industry is highly cyclical.

As significant as these premium increases have been, it is vitally important for this subcommittee to understand that they are but a part of the total liability cost problem faced by our members. Professional liability policies for A-E's are written with a deductible amount of first (investigation and defense) costs chargeable to the insured, that is *applied to each claim*. As premiums have escalated, many A-E firms have raised this deductible limit as the only way of controlling their costs. The deductible amounts now usually approach, equal, or exceed the annual premiums. This means that a design firm that does have one or more claims lodged against it in a single year can end up paying twice or three times the amount of the premium, even if none of the claims are successful. In addition to these cash expenses, the A-E firm must absorb the intangible costs of uncompensated professional time spent in investigation and defense preparation. Informed estimates indicate that a design professional spends three hours for every one hour an attorney spends in preparing to defend against a claim. Since an architect or engineer, as any professional, essentially sells his or her time, this can be a significant loss. And finally unlike manufacturing concerns, an architect must *personally* stand behind his or her loss and is not shielded by the limited liability of the corporate form.

The importance of these uninsured first costs of liability paid by the designer over and above the premium is highlighted by two factual circumstances. First, the majority of claims against A-E's are relatively small property damage claims.

From 1960 to 1976, 95.1% of the claims for which we have statistics did not exceed the deductible limits of policy coverage by more than $25,000. The average claim exceeded the deductible by $16,751 in 1976. But the average deductible amount is now between $15,000 and $20,000. This indicated that the design professions are currently satisfying a substantial portion of the costs of liability out of pocket, even with insurance.

Second, the frequency of claims is increasing at the rate of 20% per year, so that now, 29.6% of insured achitectural and engineering firms in our data base experienced claims in 1976. We simply live in a society that is ever more prone to litigation. In this connection, it should be pointed out that liability coverage for A-E's is written on a "claims made" basis. This means the insurance does not cover claims brought after a policy lapses based on acts or omissions committed during the term of the policy. So A-E's must maintain insurance, even after retirement or dissolution, for at least the length of the state's statute of limitations, if there is one.

All of this can be brought into sharper focus if put into the context of a hypothetical example: Let us assume a typical architectural firm of 8 people, the median size of our member firms, carries $150,000 of insurance with a $10,000 deductible limit. The firm might be paying $8 12,000 per year in premiums for this, indicating roughly $200,000 in gross yearly receipts. Now assume that a dispute arises over a project involving responsibility for a construction delay and a claim is filed. In the same year, a tenant in an apartment house the firm designed five years earlier sues for damage due to water leakage in one of the apartments. The firm is now potentially facing $20,000 in direct, out of pocket expenses, after paying about $10,000 in premiums, before the insurance company has even incurred a loss, and before any finding of fault is made. In this all too typical example, 15% of the firm's gross receipts can be consumed or at least encumbered by profession liability just as a cost of doing business that year, the majority of it borne by the firm itself despite insurance. And it cannot be overemphasized that this is 15% of gross receipts, before payroll, rent, utilities, taxes, other insurance, etc.

IMPACT

To appreciate the effects of this recent, crippling, financial burden, it is important to recognize that the construction design profession is preponderantly one of small businesses. Among architects who belong to the AIA, 80% work in offices of nine or fewer people. If we assume that there are about 10,000 full time architectural and engineering firms in the country, over 95% of all these firms qualify as small businesses under SBA's definition of that category.

Given this industry configuration, the impact of escalating liability costs is readily apparent. The increase in a firm's liability insurance premium *often* means the difference between laying off personnel and hiring new staff. A single claim can preclude expansion or the acquisition of more sophisticated design technologies, if not require a staff reduction.

The high cost of insurance has created a substantial barrier to the formation and expansion of new, small firms. The federal government and many states and local governments require liability insurance as a precondition to even qualify for a commission. And many if not most private clients require it as a contract condition. Therefore, because of the size of current professional liability insurance costs, a beginning architectural or engineering firm must be substantially capitalized before it can even compete for many commissions.

Of course the most important impact of the designing profession's liability predicament is the risk it creates not only for architects and engineers but the public. When a single routine claim can bankrupt a small firm, and multiple claims can bankrupt a medium sized or even a large firm, where is the protection for the public? No profession practices with pristine perfection. Errors and omissions do occur and we carry insurance in recognition of that fact. But when this insurance is so costly as to be prohibitive for some firms and the liability exposure even with insurance is so great as to threaten the financial stability of the best practitioner, the just claimant may have no source of recovery. And it is not solely our clients who are exposed to this risk. Just as manufactured products enter the stream of commerce, the buildings and structures we design are used by the public to live and work in and travel on for decades. The design professional's liability exposure, and thus the public's risk and need for protection, is at least as great as that for manufactured products.

BEGINNINGS OF A REMEDY

Because of all the factors outlined above, we strongly urge the inclusion of construction design professionals within the coverage of the self-insurance tax bill before you. H.R. 7711, with its sixty some co-sponsors, and S. 2864 include professionals. In the area of construction designers, we believe the ability to establish liability loss reserve accounts would be almost wholly used to cover exposure to first costs under insurance deductible limits. Because of the preponderantly small business nature of the profession and the high cost of the structures being designed, very, very few firms would or could attempt to totally self insure. Virtually all architects who would elect to create a reserve account would do so in conjunction with purchased insurance to cover catastrophic losses. In fact, total self insurance to the level of industry standards would be impossible under S. 3049, since that bill limits accumulation in a reserve account to a maximum of 15% of yearly gross receipts, whereas most A–E's carry insurance far above that percentage.

Design professionals currently are, in effect, self insuring to an extent because of the limited nature of commercial insurance available. Existing tax law allows a deduction for purchased insurance premiums and actual uncompensated liability losses incurred. S. 2864 would simply allow a commensurate deduction for a reserve account to meet the same costs of doing business, but on a manageable more predictable basis. With a liability loss reserve account, an A–E firm could slowly build up a reserve to cover its exposure to the first costs of claims.

As the account grows, the firm could raise the deductible limit on its purchased insurance, thereby reducing or at least stabilizing premiums. The growth of the reserve would depend on the lack of claims, so these accounts would encourage and reward good performance much more than the current situation.

For new, small firms or sole practitioners just beginning, the ability to establish a reserve account would allow then to immediately set aside funds and gain some liability protection without having to wait until they can afford purchased insurance. And when a new practice does buy commercial coverage, a growing reserve account could help the firm get it cheaper. In this respect, should the Subcommittee include designers in this bill, we would hope some language could be included in the report indicating the intent that amounts in these reserve accounts be considered on a par with commercial coverage in satisfying federal, and hopefully state, requirements for liability coverage in procurements.

We recognize there may be reluctance on the part of the Subcommittee to extend coverage of liability loss reserve account legislation to all professions, since not all professions have similarly acute liability problems. Other professions have greater economic resources or greater institutional and legal protection from liability claims. But we strongly believe architects and engineers do have a problem so acute and a degree of exposure so great that coverage under the bill before you is warranted. Should you decide to allow construction designers the election option put forward in S. 3049, we offer the following suggested language to accomplish that end:

Amend section "(9)(A)" regarding the definition of product liability by inserting a colon after the phrase "or defects in" and amending the remaining portion of the section to read as follows:

"(1) A product manufactured, imported, distributed, leased, or sold by the taxpayer or, (2) the professional design, planning, evaluation, preparation of specifications, or administration of a contract by the taxpayer (whether in whole or in part) for the construction or modification of a building or structure on real property."

The restrictions in S. 3049 designed to limit eligibility to small businesses present few problems. Our members are small businesses and would generally come within those restrictions. In fact, the majority of our member firms would qualify as having a "severe liability insurance problem" now, and the maximum contribution limits are beyond the capability of all but a few firms.

Of course, anytime a new deduction is proposed, the question of budget or revenue impact must be raised. We have not heard of any accurate or reliable estimate being made at this point. All the estimates we know of either assume everyone eligible would establish a reserve account or do not discount the deductions already being taken. Intuitively, we believe extending the option of a liability

loss reserve accounts to design professionals would not result in a significant revenue loss. Again, premiums and incurred uncompensated losses are already deductible. The revenue loss due to these existing business deductions would be absorbed or replaced by deductions for contributions to these accounts. To the extent that premiums for purchased insurance, that can now be deducted, are reduced, there may even be an offsetting revenue gain. We view liability loss reserve accounts for architects and engineers not as some potential windfall for these professions but as recognition of the fact that designers must now self-insure their liability exposure to large extent. On that circumstance, reserve accounts would simply treat small professional firms on an equal basis with insurance companies.

ADMINISTRATION PROPOSAL

Despite the preliminary endorsement of pre-tax liability reserves by the Departmentof Commerce, the administration has now proposed an alternative tax plan for liability troubled industries. This calls for extending the loss carry-back period from three to ten years. We, unfortunately, cannot agree with this as an alternative due to three reasons: (1) lack of efficacy in addressing the problem, (2) potential for complexity and expense to the taxpayer, and (3) impracticality in operation.

(1) The extended loss carry-back proposal simply does not address the central problem of high premiums and high deductibles. No firm could reduce its premium simply by saying it had large prior profits that it might get a refund on should a claim arise. And the problem of high deductibles would not be affected at all since a firm would have to exhaust its current income against a loss before filing for a refund of prior years' taxes.

(2) While the IRS may view the extended loss carry-back as administratively simple, it is a potential nightmare of expense and complexity for a professional small business. Most professional firms such as architects operate as partnerships, closely held professional corporations, or Subchapter S corporations. In most of these situations, the principles are taxed directly, with income passing through the business entity. For a typical firm of three or four partners to take advantage of the Administration's 10 year loss carry-back would therefor require the filing of 30-40 amended tax returns. The complexity and cost of this alone could discourage anyone from using this concept.

(3) The extended carry-back concept, as stated above, does nothing about the problem of high out-of-pocket costs under deductible limits. In addition, it is very unclear how this concept would actually work in the real world of small business liability. The concept presumes that a business will have cash on hand to pay any judgment and then wait for a refund (assuming a judgment must be entered before the loss is accrued for tax purposes). This simply is not the case with small businesses facing judgments in excess of insurance coverage. And we see nothing in this concept which would convince a judgment creditor to forestall executing its judgment against firm and personal assets beyond the mere possibility of extracting multiple tax refunds at some undetermined future time.

For these reasons, we see the administration's proposal as no remedy at all in the area of architect's professional liability.

STATEMENT OF FARM AND INDUSTRIAL EQUIPMENT INSTITUTE (FIEI)

Rather than explicate S. 1611 and S. 3049, FIEI would like to address the concepts which it feels should be incorporated in any legislation which is enacted which authorizes the creation of tax exempt product liability trusts.

CONSTRAINTS TO BE PLACED ON THE RESERVE

1. Funds which are placed in reserve are irrevocable and should only be withdrawn for a specified, acceptable purpose. If funds should be otherwise withdrawn the amount withdrawn should then be subject to normal tax treatment.

2. Income earned on the assets of the trust should be subject to the normal rate of taxation or permitted to be reinvested or placed back into the fund as part of the fund.

3. The reserve should apply only to the uninsured portion of liability exposure.

4. A yearly evaluation of the trust by an independant accounting firm should be required.
5. Reserves should be confined to FDIC insured banks or government backed bonds.

COVERAGE OF THE CLAIM RESERVES

Payments from the claims reserve should be extended to payment of judgements, settlements, costs of defense, and all other unallocated litigation expenses.

ACCUMULATIONS UNDER THE RESERVE FUND

The amount placed in the reserve should be restricted to claims made against the company.[1] If it is necessary to limit the reserve FIEI recommends utilization of a floating base premised upon 120%, or such other measurement base as may be appropriate, of the cumulative claims made over a specified base period)e.g. the proceeding three years), taking into account inflationary factors. Punitive awards should be treated as an exception to the reserve limitation.

INCLUSION OF CAPTIVE INSURANCE COMPANIES

FIEI would like to see the concept of a reserve trust be extended to include captive insurance companies. The fashion in which a reserve is held should be immaterial since there is an obvious advantage to pooling and ability to spread risk through re-insurance, especially in the case of catastrophic loss.

DEFINITION OF A SEVERE PRODUCT LIABILITY PROBLEM

The definition of a "severe product liability problem" should not be tied to a percentage of sales but rather should be a function of the volume of business and the type of product involved. The definition under S. 3049 should be expanded to include companies with first dollar coverage. Further, some provision for a new company or a company with a new product should be made.

FIEI members have examined the Administration's proposal to extend the net operating loss-carryback attributable for product liability losses for ten years. Undoubtedly in the case of catastrophic or large losses the seven year extension of the loss-carryback proposed by the Treasury Department is of benefit. We are presently reviewing the Administration's loss carry-back bill for its tax implication and will supplement this testimony with our findings as soon as possible. The current tax deduction that the Administration's proposal would afford is by its very nature not as timely and certainly more costly to the Federal government than a deferral of taxes for contributions made to the self-insurance reserve trust. Further, the Treasury proposal would not benefit those companies which experience a large number of small claims on a regular basis or those companies with claims which need not be carried back further than the existing three year rule. The final short-coming FIEI sees in the Administration's ten year loss-carryback is that it does not address the question of the ability of a manufacturer to obtain insurance coverage that will satisfy the individual corporation's needs. FIEI does contend however, that the Administration's proposal does have some merit but should not be enacted in lieu of legislation which permits the creation of a product liability self-insurance reserve trust.

In conclusion, FIEI supports the enactment of legislation which would permit the creation of product liability self-insurance reserve trusts. The Institute contends that these funds would promote loss prevention techniques specifically if the trusts were extended to include such costs. Certainly the reserve fund permits a higher level of deductibility in insurance coverage such that excess coverage insurance will become more affordable in the eyes of industry. This in turn would have the affect of increasing the long term tax revenues to the IRS. Finally, where companies experience a problem in obtaining insurance for a newly developed product for which liability coverage is unobtainable, the self-insurance reserve trust is the ideal solution. For the reasons we have enumerated FIEI feels that the logical course for the Administration and Congress would be to enact legislation such as S. 1611 with the qualifications we have made. In so doing, one of the major hurdles in the product liability arena will be eliminated.

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[1] Some contingency must be made to permit companies with no claims records to participate in the reserve.

Statement of Southern California Edison Co.

This statement is filed on behalf of Southern California Edison Company ("Edison"), an investor-owned public utility providing electric service in a 50,000 square-mile area of Central and Southern California. This service area includes some 800 cities and communities with a population of nearly eight million people. Edison's gross investment in plant facilities totals almost $6.2 billion.

SUPPORT OF S. 3176

Edison supports S. 3176 which, if adopted, would amend Section 118 of the Internal Revenue Code to exclude from gross income amounts received as contributions in aid of construction by electric and gas utilities in the same manner that similar amounts have been statutorily excluded from the gross income of water and sewage disposal utilities. If S. 3176 is passed, such contributions in aid of construction would be treated as contributions to capital and thus excluded from gross income.

CONTRIBUTIONS IN AID OF CONSTRUCTION

Edison, like other electric utilities, acquires contributions in aid of construction when a customer requests facilities the revenue from which would not justify the investment. If Edison were to engage in construction of such facilities using only its funds, the cost of such facilities would have to be recovered through rates charged to all customers—not just those customers receiving the benefit of the constructed facilities. In order to remove this burden from its customers generally, non-refundable contributions of cash or property are received from the customer requesting the facility.

Contributions in aid of construction are received under the terms of written contracts entered into between Edison and the contributing party. Edison uses the contributions for construction of the specified facility. For accounting and ratemaking purposes, the Federal Energy Regulatory Commission and the California Public Utilities Commission, which agencies have accounting and regulatory jurisdiction over Edison, require that the contributions be credited to the same balance sheet account as those in which the construction costs are capitalized. Thus, the property constructed by such contributions does not increase Edison's rate base (plant investment) upon which it earns a return. The Internal Revenue Service has also required that the contributions be removed from the property basis used in calculating investment tax credit and tax depreciation.

Public utilities have traditionally received non-shareholder contributions in aid of construction without including them in taxable income. The Internal Revenue Service has in the past acquiesced in a number of cases which held that contributions in aid of construction did not constitute taxable income.[1] In 1958, as a result of a holding in *Teleservice Co. of Wyoming Valley* v. *Commissioner of Internal Revenue*, 27 T.C. 722 (1957), aff'd 254 F.2d 105 (3rd Cir. 1958), which stated that contributions in aid of construction received by a nonregulated utility are taxable, the Internal Revenue Service issued revenue ruling 58-555 affirming their prior position that contributions in aid of construction received by a regulated public utility constituted non-taxable contributions to capital. In 1975, based on the rationale of a 1973 Supreme Court decision which involved depreciation and set forth characteristics of non-shareholder contributions to capital,[2] the Internal Revenue Service issued revenue ruling 75-557 which held that connection charges received by a regulated water company were taxable income and did not represent contributions to capital. Although this ruling dealt specifically with connection charges of a water company, it removed the public utility distinction which was previously the basis for excluding contributions in aid of construction from taxable income. Although revenue ruling 75-557 applied to a water com-

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[1] *Appeal of Liberty Light & Power Co.*, 4 B.T.A. 155 (1926); *Great Northern Railway Co.* v. *Commissioner of Internal Revenue*, 8 B.T.A. 225 (1927); *Rio Electric Co.* v. *Commissioner of Internal Revenue*, 9 B.T.A. 1332 (1928); *El Paso Electric Railway Co.* v. *Commissioner of Internal Revenue*, 10 B.T.A. 79 (1928); *Wisconsin Hydro-Electric Co.* v. *Commissioner of Internal Revenue*, 10 B.T.A. 933 (1928); *Tampa Electric Co.* v. *Commissioner of Internal Revenue*, 12 B.T.A. 1002 (1928); *Kauai Railway Co.* v. *Commissioner of Internal Revenue*, 13 B.T.A. 686 (1928); and *The Baltimore and Ohio Railroad Co.* v. *Commissioner of Internal Revenue*, 30 B.T.A. 194 (1934).

[2] *Chicago, Burlington and Quincy Railroad* v. *United States*, 412 U.S. 401 (1973).

pany, the Internal Revenue Service is applying the principles of the ruling to a broad range of contributions in aid of construction (including some contributions made to electric and gas companies).

In the Tax Reform Act of 1976 Section 118 of the Code was amended to provide that contributions in aid of construction made to water or sewage disposal utilities which are used for qualified expenditures that are not included in rate base are to be treated as nontaxable contributions to capital. This amendment originally included electric and gas utilities as well as water and sewage disposal utilities. However, when finally ordered out of Committee, the exclusion was limited to water and sewage disposal utilities. S. 3176 would provide for similar treatment for electric and gas utilities and thereby bring them within the provisions of Section 118 as amended by the Tax Reform Act of 1976.

THE NEED FOR S. 3176

Without the amendment of Section 118 proposed by S. 3176 Edison could be required to pay income tax on contributions in aid of construction which it receives. Such additional income taxes would result in: (1) higher rates for electric energy charged to all ratepayers or (2) imposition of the additional tax on the party making the contribution or (3) a financial burden on Edison's shareholders to the extent that regulatory bodies exercising ratemaking jurisdiction over Edison do not allow for the total recovery of such higher taxes. Any of these results would have a detrimental impact on the cost of electrical energy.

The possible inclusion of contributions in aid of construction in gross income is a significant matter to Edison. Edison annually receives from six to ten million dollars in contributions in aid of construction. This does not include large items which under a broad definition of contributions in aid of contruction may arguably be includable, for example: governmental and private industry contributions to technologically advanced projects and properties operated on Edison's facilities for the benefit of third parties. The taxation of these contributions would have a signifiicant impact on Edison's cash flow. In terms of absolute dollars, when income tax reductions associated with investment tax credit and future depreciation deductions are fully realized, Edison and its customers will have recovered all the taxes previously paid. However, until these tax benefits are received, Edison would have an immediate tax outlay with a resultant detrimental impact on current cash flow.

SUMMARY

Edison believes that Section 118 of the Internal Revenue Code should be amended to exclude from gross income contributions of capital received by electric and gas utilities. This treatment would simply be in accord with the treatment of such contributions already approved by Congress for water and sewage disposal utilities.

Such an amendment would remove the need to increase electric rates to recover taxes on contributions in aid of construction, and could remove the possibility of having the Company's shareholders bear a portion of the burden imposed by such higher taxes.

Edison supports S. 3176 because it removes the inequality which now exists between water and sewage disposal utilities and electric and gas utilities, and because Edison believes such legislation to be in the best interests of both its customers and shareholders.

LAW OFFICER OF HUNTON & WILLIAMS,
Washington, D.C. August 28, 1978.

Senator HARRY, F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt, Management,
Senate Finance Committee,
Dirksen Senate Office Building,
Washington, D.C.

DEAR MR. CHAIRMAN: Your announcement (P.R. #64, dated August 18, 1978) of a hearing on August 28, 1978 on miscellaneous tax bills states that the Subcommittee would be pleased to receive written testimony for the record. The list of bills in your announcement includes S. 3176, introduced by Senator Laxalt to allow public utilities to exclude from gross income, as contributions to capital, amount received in aid of construction of electrical energy, steam, or gas facilities.

As you know, our firm represents Virginia Electric and Power Company (Vepco), an investor-owned electric company, which generates and supplies electricity throughout the State of Virginia. Like other electric utilities, Vepco receives contributions in aid of construction.

For almost fifty years, contributions in aid of construction to regulated public utilities have been excluded from gross income and treated as contributions to capital. However, on December 4, 1975, the Internal Revenue Service issued Revenue Ruling 75-557, 1975-2 C.B. 33, which reversed IRS's prior position and announced that amounts received after February 1, 1976 would be includable in gross income. That ruling confused the long-standing historical treatment of payments to utilities in aid of construction. The Tax Reform Act of 1976 eliminated the confusion for regulated public utilities providing water or sewerage disposal services, but failed to clarify the issue for regulated electric and gas companies.

Generally, contributions in aid of construction are payments by the customers of a public utility for all or a portion of specific construction costs incurred to extend service in excess of a prescribed standard established by the applicable regulatory commission. Typically, they are payments made to extend utility service long distances or into isolated areas where use of the utility's own funds would not be justified from the standpoint of return on investment. If the facilities were built without receipt of any contributions in aid of construction, the cost of such facilities would be borne in part by customers who receive no service or benefits from them.

Contributions in aid of construction have the following additional features:

The utility is compelled by contract and regulatory requirements to use the contributions received solely for construction of the facility. Rules of both the Federal Energy Regulatory Commission and of most state regulatory agencies require this result.

The property constructed for customers with such contributions is not depreciated for book purposes and is excluded from rate base. The utility cannot earn a rate of return on such property.

No investment tax credit or depreciation is allowable for Federal income tax purposes with respect to such property.

Reimbursements utilities receive from government agencies for costs incurred in relocating their facilities to accommodate governmental projects traditionally have been excluded from gross income in a manner similar to the treatment of contributions in aid of construction. Customer connection or reconnection fees (payments made by a customer to have utility service turned on or off or to have service supplied within normal prescribed limits), however, have not been excluded from income by the gas and electric industry. These fees are taxable as income, and no change in the treatment of connection fees is contemplated by this proposal.

Failure to treat payments to electric energy, gas, and steam utilities as contributions to capital creates a serious inequity between them and water and sewerage disposal utilities. To the extent the tax liability is not reimbursed by increasing the amount of the contribution, utility rates will have to be increased to pay for the tax, which would effectively force all utility customers to subsidize these projects. The alternative is to increase substantially the contribution amount to provide sufficient funds to pay the tax liability on the contribution and to complete the construction work.

This alternative will drive up the cost of new housing. By taxing contributions in aid of construction received by utilities, a builder or developer is required to pay substantially higher front-end costs, which contributes to the accelerating housing cost problem. These costs are ultimately passed on to the consumer. Such result makes it more difficult for the average American family to afford the purchase of a new home. The inequity of the taxable treatment of contributions in aid of construction also increases the cost of public projects that require the relocation of utility facilities.

Section 118 of the Internal Revenue Code should be amended to confirm the long-standing rule that contributions in aid of construction, and amounts similarly treated, such as highway relocation reimbursements, do not constitute gross income to regulated electric, gas, and stream utilities. The Tax Reform Act of 1976 confirmed this treatment for regulated public utilities providing water or sewerage disposal services as long as the contributions or property purchased with these amounts are not included in the utility's rate base for ratemaking

purposes. The same treatment should apply to comparable payments received by regulated electric, gas, and steam utilities.

Since contributions in aid of construction and relocation costs have been regarded as non-taxable for over fifty years, to continue to treat them as non-taxable results in no net revenue loss. The proposal only codifies the historic treatment of these amounts as non-taxable.

In behalf of Vepco, we urge the Subcommittee to report S. 3176 favorably.

Very truly yours,

JOHNNIE M. WALTERS.

AMERICAN BANKERS ASSOCIATION,
Washington, D.C., August 28, 1978.

Re S. 1611 and S. 3049, Self-Insurance for Product Liability, hearings on miscellaneous tax bills, August 28, 1978.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management,
Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR BYRD: The American Bankers Association is a trade association composed of 13,254 banks, about 92 percent of the banks in the United States. Approximately 4,000 of our member banks have fiduciary powers, and for this reason we are interested in the proposals being considered by your Subcommittee to allow businesses to utilize self-insurance to cover product liability claims. We would like this letter to be included in the hearing record on S. 1611 and S. 3049.

A great deal of interest has been shown in the problems of businesses obtaining adequate insurance coverage for product liability at reasonable costs. The Federal Interagency Task Force on Product Liability spent eighteen months studying this problem, the U.S. Department of Commerce issued an "Options Paper on Product Liability and Accident Compensation Issues" earlier this year based on the findings of the task force, a number of different proposals have been suggested in bills introduced in each house of Congress, and recently the Administration announced a program to deal with this problem. Those who have been deeply involved in the product liability insurance issue realize that there is need for both short-term action to design a way for businesses to handle their current liability insurance needs and long-term action to review state product liability laws.

We feel the concept of self-insurance which is basic to S. 1611 and S. 3049 will benefit businesses and their customers. Both bills include provisions to have the self-insurance funds placed in trusts with banks or other persons qualified by the Internal Revenue Service acting as trustees. We agree that the trust arrangement will provide the best safeguard to assure that the funds are used only for the purposes intended, i.e. to cover product liability claims, the expenses of resolving such claims, and the cost of administering the trust. Banks have experience in offering a wide range of trust services at reasonable fees and will be able to tailor their services to meet the needs of companies which decide to utilize this self-insurance approach.

We do not feel Congress should restrict by statute investments in which the assets of the product liability trust can be placed. This type of self-insurance fund would understandably need an investment policy to provide stability of the corpus and reasonable, low risk growth. However, we feel that the statute should not preclude investment in corporate stocks and bonds as long as the investment course pursued is responsive to the purpose of establishing this type of trust.

We also believe Congress should not try to set statutory limits on the amount of deductible contributions allowable to product liability trusts. We think the best approach would be to give the Secretary of the Treasury authority to set limits according to a general Congressional directive that the deductible contribution cannot exceed the reasonable cost that the company would otherwise incur to obtain product liability insurance. We realize that determining these limits will not be easy and that opponents of this legislation will say there might be abuses. However, various businesses are subject to differing levels of liability exposure and an across-the-board percentage or dollar limit will be self-defeating in establishing a workable product liability trust program. Although we are less than enthusiastic about leaving this matter to regulatory determination, we feel

that this approach is the only way to really provide individual businesses with the protection they need.

We hope our comments will be helpful to your Subcommittee in formulating a bill to allow product liability trusts.

Sincerely yours,

ROBERT L. BEVAN,
Associate Federal Legislative Counsel.

STATEMENT OF THE AMERICAN MINING CONGRESS

Mr. Chairman, Members of the Committee: The American Mining Congress appreciates the opportunity to present its views to you. The issue before you is of vital interest to our members, and we hope this statement will be helpful to you in dealing with the proposed legislation you are considering.

The American Mining Congress is a national association of U.S. mine operators and manufacturers of mining machinery and equipment that produce the greater part of our nation's metals, coal, and industrial and agricultural minerals. Our manufacturer members are particularly concerned with the product liability issue.

It is almost universally agreed that there is a product liability problem. Its causes are complex, involving such diverse areas as our tort system, manufacturing processes, and insurance rate-making procedures; hence, the variety of suggested solutions to the problem, both short and and long-range. These particular hearings focus primarily on interim measures aimed at alleviating the spiraling cost of insurance premiums, which is one of the most serious symptoms of the basic problems.

According to the Federal Interagency Task Force Report on Product Liability and Accident Compensation Issues, rates in the product liability area averaged an increase of 300% during only the short period from 1975 to 1977. These increases are either reflected in the prices of products being sold, or they have resulted in businesses being operated without insurance coverage.

When business cannot afford insurance and take the risk of going bare, no one wins. The insurance company loses, having lost a policy; the consumer is insufficiently protected against injury; the business itself is left in a "shoft-shelled" condition, exposed to potential bankruptcy; and employee job security is in jeopardy.

It is with a view to alleviating this highly undersirable situation that members of this Committee, with the strong support of many other Members of the Congress, have introduced bills that will provide sensible relief to burdensome, or in some cases cost-prohibitive, insurance by premitting the creation and maintenance by the taxpayer of tax-exempt trusts or reserve accounts specifically set up to cover product liability claims. The purpose of this statement is to deal with only this part of a recognized overall solution. In this connection, we note this great interest that the Final Report of the Department of Commerce Options paper on Product Liability and Accident Compensation points out the need for this type of interim action.

While the unavailability of product liability insurance does not appear widespread, some companies do have difficulty obtaining it. For others, the rapid escalation of liability insurance premiums has made such insurance unaffordable -- a practical equivalent of unavailable.

The Internal Revenue Code presently permits a business to deduct a product liability loss from current earnings only after a loss has been *incurred*, in the case of an accrual basis taxpayer, or the settlement *paid*, in the case of a cash basis taxpayer. (IRC Sec. 165) Similarly, the accrual or payment of product liability insurance premiums is a deductible business expense. (Reg. Sec. 1.162-1) On the other hand, neither the mere accrual of a liability for a contingent loss nor the funding of a self insurance trust to pay such losses is currently deductible. The enactment of some tax incentive for self-insurance would encourage individual firms to self-insure for increased deductible loses, thereby reducing their premium cost for insurance coverage on the balance of such losses.

Self-insurance reserves offer a needed alternative for the businessman who may now be faced with a form of "red-lining" by insurers despite what may be an excellent individual loss record. By providing a competitive alternative, self-

insurance reserves will strengthen the bargaining position of insureds in dealing with insurance carriers, and will help to combat the steeply inflationary trend we have witnessed in products liability insurance premiums.

In explaining how the public will be benefitted by the creation of an enlarged pool of funds to compensate injured consumers, the tax attributes of a deductible product liability reserve will be examined from five aspects; viz. 1) funding, 2) deduction limitations, 3) withdrawal, 4) taxability of reserve fund income, and 5) applicability of accumulated earnings tax.

FUNDING

Accounting reserves generally fall into three categories:

1. Asset valuation reserves, e.g., reserves for bad debts and depreciation.
2. Liability reserves, a misnomer for fixed or determinable accrued liabilities.
3. Appropriated surplus reserves, i.e., a segregation of earning to cover future contingencies.

We are dealing with the third type here. Product liability losses may never occur. They are admittedly contingent. Therefore, any tax incentive for self-insurance should be constructed in a way as to minimize chances of it becoming a new "tax loophole". This was perceived to be the flaw, for example, in the ill-fated IRC Sec. 462, Reserve for Estimated Expenses, enacted in 1954 and retroactively repealed in 1955. What is sought here is a currently deductible substitute, in whole or in part, for an insurance premium, which represents a nonrecoverable cash outlay. The objective is to aid taxpayers with product liability exposure to set aside a pool of assets with which to compensate injured consumers, with variations in the degree and mode of fundings.

While it is true that some businesses may not be as able as others to take advantage of the trusts, "it can do nothing but help", as Congressman Whalen has pointed out. This is true because even though only a small amount can be contributed to the reserve each year by a business with a small cash flow, to be able to reserve anything is better than no coverage at all, and a number of small deposits over a period of time can generate a large reserve.

The building of reserves will also allow an insured company to enjoy lower insurance costs by absorbing more primary risks through deductibles. The reason that insurers are willing to reduce premiums if the insured will take a deductible is that the insurer will statistically have less frequent liabilities. And because even a small business (which may not be able to afford in-house legal or insurance staff) will be able to accumulate some amount, deductible will be more available to all who create a trust under this proposed amendment to the Tax Code. The collateral effect of inducing the insured to draw off the primary risks of the marketplace would seem to to be to increase the insurance company's capacity because it would relieve them of the burden of higher risks in the market.

Most current proposals contemplate 100% funding of any current deduction. However, when a large part of the problem is the unaffordability of product liability premiums, to require concurrent 100% funding of a substitute deduction may make the "cure" as bad as the "disease". Certainly the taxpayer should not enjoy any windfall benefit from the deduction and therefore should be required to fund at least the incremental amount of tax saved by the deduction, i.e., 48%, rounded to say 50%. Further, as a quid quo for the current deduction and in order to build up a segregated asset fund equal to the liability reserve, it may be considered reasonable to require funding of the remaining 50% of each annual reserve addition, if any, over a relatively short period of years.

As to the mode of funding, there are three possibilities, viz., an IRC Sec. 501(c) tax-exempt trust, a taxable grantor trust, or a taxable self-administered segregated fund. The after-tax asset accumulation of a tax-exempt trust will be exactly the same as in the taxable trust or fund where the income from the latter also is dedicated to the fund. This consideration being equal, a taxable reserve fund concept, psychologically, may be more palatable than a tax-exempt reserve fund which carries with it tax shelter overtones. In addition, the restrictions usually associated with tax-exempt trust are incompatible with the admittedly contingent and therefore potentially revocable nature of the product liability reserves. It might be noted that funding through a taxable grantor trust would provide adequate fiduciary protection against taxpayer manipulation while avoiding some of the administrative complexities usually associated with a tax-exempt trust.

To secure a deduction for the reserve addition for any taxable year, the related funding requirement should be considered timely met if made not later than the

last day prescribed by law (including extension thereof) for filing the taxpayer's return for such year.

Permitting a current deduction for possible future losses is a tax-deferral mechanism. The deduction should be limited in a way that does not lend it to abuse of use as a tax shelter for unrelated income. The limitation should be readily determinable by reference to objective (rather than subjective) standards to minimize audit problems. Thus, limitation tied to annual and cumulative percentages of gross receipts from the product line for which loss protection is sought (S. 1611, Culver (D-IA) and S. 3049 and H.R. 12249, Commerce Dept.) appears preferable to the more ambiguous standards such as "market value" or "reasonable cost" of insurance coverage as in other legislative proposals. This is particularly so where insurance ratemaking procedures have been cited as one of the root causes of the present problem. There should be no distinction made between taxpayers having a "severe product liability insurance problem" and those who do not, as in the Commerce Department draft bills, H.R. 12249 and S. 3049. An adequate funding requirement coupled with reasonable limitations should be sufficient to prevent taxpayers from accruing and deducting beyond their reasonably anticipated needs.

Regarding limitations on tax deductibility, we believe that any flat dollar limitation should be eliminated and a tax deduction for estimated incurred losses on an annual basis permitted. In addition, allowances should be made for losses incurred but not reported. Where necessary, certification by an individual actuary as to the adequacy of reserve accounts should be provided.

WITHDRAWAL

Because of the contingent nature of the reserve, withdrawal of funds in excess of anticipated needs based on experience should be permitted. Amounts withdrawn for use for purposes other than product liability and costs related thereto would be included in the taxpayer's gross income for the year of withdrawal. No other penalties for withdrawal should be attached.

TAXABILITY OF RESERVE FUND INCOME

Net income earned on assets in the reserve fund should be currently taxable to the taxpayer as equitable owner of the fund. The taxpayer should have an annual election as to whether he wishes to transfer all or any portion of such net income to his product liability loss reserve account within the deduction limitation and funding requirements established. To the extent he elects to transfer the net income to the liability reserve account, that amount will stay in the asset fund and will count as a part of his deduction for reserve addition for the year, fully funded. Only the balance of the annual or cumulative deduction limitation may be claimed for the year and funded under the 50–50 rule. To the extent the taxpayer's deduction for reserve addition is less than the net income amount, whether by choice of by limitation, the excess should become part of the taxpayer's general corporate funds.

It has been argued that the proposed legislation would result in lost tax revenue for the government. Thus, a response to this point of view is in order. Actually, the U.S. treasury would lose very little money if any, because the amount of pre-tax revenue otherwise used for purchasing insurance is the limit of tax-free trust contributions. Moreover, insurance premiums are a business cost anyway and reduce taxable income. The only way the Treasury Department could possibly lose revenue is where the self-insurer had not been able previously to obtain insurance. But, this is not relatively significant. Moreover, if the taxpayer cannot buy insurance to cover himself, should we not then provide an alternatiev and encourage him to self insure in the best interests of everyone. It has also been said that the treasury would lose revenue where the insured insures both commercially and to the fullest extent with his own tax-free reserves. But, as Professor Schwartz of the Department of Commerce has noted, it is unlikely that a company will self-insure unless his premiums are extremely high; "otherwise, his is better off buying insurance."

In sum, we are faced with a serious situation deserving immediate relief. The type of legislation being proposed is sufficiently restrictive to avoid abuse. It is appropriate medicine for relieving the "symptom" being endured. It contains appropriate mechanisms to restrict its use to those who can use it. It is readily implemented. We urge the Congress to adopt Tax Code amendments of this kind forthwith.

STATEMENT OF THE AMERICAN LEGION BY MYLIO S. KRAJA, DIRECTOR, NATIONAL LEGISLATIVE COMMISSION, ON S. 2771 RELATING TO INCOME TAX EXEMPTIONS

Mr. Chairman and Members of the Subcommittee: The American Legion appreciates this opportunity to present our views and recommendations on proposed legislation to amend the Internal Revenue Code of 1954 to treat the conducting of certain games for tax-exempt organizations as not being an unrelated trade or business.

Numerous bills have been introduced during the 95th Congress to overturn a recent court decision in the State of Minnesota that concluded that a VFW Post, which operated a weekly bingo, was liable for unrelated business income tax. This decision could very well pave the way for the IRS to begin collecting taxes from many non-profit charitable and civic organizations across the country who run weekly bingos.

The legislation being considered this morning would simply amend two sections of the Internal Revenue Code to clarify the intent of Congress that non-commercial bingos that do not violate State law are not considered an "unrelated trade or business".

The American Legion has used bingo as a fund raiser for a number of years in order to assist many charitable and civic programs. We have never kept statistics on the total amounts bingo has generated within our state Legion department; however, our national organization conducts a qualitative analysis each year of The American Legion Posts' involvement in their communities—both civic and charitable. We call this method our Consolidated Post Reporting system, which is broken down into 69 categories.

We are certain that there are very few American Legion Posts that could carry on their civic and charitable work strictly through the dues they are paid by our 2.7 million members. Recently we conducted a survey to determine the average amount of American Legion dues and discovered the following: The Average dues for 12.129 American Legion Posts who participated in our direct renewal program is $9.84. This reflects approximately 80% of our members or, to put it another way, 2.117.304 members. The $9.84 figure included $3.50 national per capita and an average of $3.00 department per capita, which leaves the posts an operating revenue of $2.14 per member to carry on their civic and charitable programs.

Since this is a very small sum, many of our posts have successfully used bingo to augment the fund raising activities needed to carry out successful civic and charitable programs. From the 1976–77 Consolidated Post Reports (attached), posts contributed very heavily to numerous charitable and civic programs. As an example, $2.940.784 was earmarked for our Boys State program which familiarizes participants on how governments of our land operate; $3.000.802 was spent on Legion Baseball and Little League programs; contributions exceeding $2 million were made to mental health, retarded children, crippled children, etc. Uniformed groups, including high school bands, receive over $1.2 million.

We believe it is safe to assume that most of the money generated in America's communities by American Legion Posts was the result of fund raising activities such as bingo. As an addendum to this statement, you will find a summary of reports furnished by American Legion Posts from 1976–77.

National Summary—1976–77 Reports by American Legion Posts

GENERAL

Item	
2. Post Number	0
3. 77 members	1, 488,173
4. 76 members	1, 559, 024
5. Initiated	39, 122
6. Assets	360, 808, 299
7. Form 990	4, 342
8. Debt free	3, 481
9. Mortgage	1, 073
10. Rented	471
11. No Cost	710
12. Other	385

REHABIITATION

13. Rehab cases	413, 790
14. Form 23-222	81, 850
15. Aid amount	571, 940
16. VAVS hours	935, 463

AMERICANISM

Boys State

17. Number boys	15, 537
17. In program	5, 089
18. Cost Boys State	1, 094, 784

Baseball

19. Legion baseball	1, 979
20. Other team	2, 146
21. Team costs	3, 802, 077

Scouting

22. Scout unit	1, 460
23. Number youths	42, 140
24. Number members	8, 467
25. Scout costs	352, 699

School awards

26. School awards number	20, 467
26. In program	3, 556
27. Award costs	233, 100

Oratorical contest

28. Oratorical	900
29. Number youths	6, 092
30. Costs	74, 410

Education and scholarships

31. Scholarship cost	441, 556

Patriotic events

32. Veterans Day	4, 360
33. Memorial Day	6, 060
34. July 4	3, 537
35. Legion birthday	4, 691
36. American Education Week	1, 040
37. Sponsor flag education	1, 873

Community service

38. Hours given to community service	2, 282, 431
38. In program	4, 488

Employment

39. Economic	1, 011
40. Jobs found	41, 758

Contributions to

47. Mental Health	62, 612
48. Retarded	217, 273
49. C/W Foundation	21, 914
50. Other contributions	1, 087, 070
51. United Fund	179, 150
52. Red Cross	66, 058
53. Cancer	259, 285
54. Crippled Children	122, 091

CHILDREN AND YOUTH

41. Cash C. & Y	820, 689
42. Goods C. & Y	1, 007, 710
43. Extras C. & Y	1, 158, 626
44. Other C. & Y	886, 191
45. Number direct aid	168, 941
46. Number other	883, 132

NATIONAL SECURITY

55. Pints blood	102, 953
56. Donors	61, 022
57. ROTC medals	3, 220
58. AERO medals	69
59. Number boys sponsor	929

PUBLIC RELATIONS

60. P.R. chairman	3, 133
61. Post paper	2, 452

LEGISLATIVE

62. Legislative	2, 236

UNIFORMED GROUPS

63. Color guard	3, 325
64. Firing squad	3, 032
65. Drum and bugle corps	277
66. Band	145
67. Drill team	367
68. Other	283
69. Costs	1, 206, 611
70. Percent of all posts reporting	43. 78

STATE BOARD OF INSURANCE,
Austin, Tex., August 31, 1978.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: As Chairman of the Task Force on Products Liability of the National Association of Insurance Commissioners (NAIC), I submit the following remarks for the record of hearings Monday, August 28 on federal legislation to establish incentives for self-insurance under the federal tax laws against product liability risks. I have also served as Chairman of the Advisory Committee to the Under Secretary of Commerce in connection with the Federal Interagency Task Force on Product Liability. I regret that short notice about your hearing and previously scheduled official business prevented me from appearing in Washington.

The objectives of the NAIC are (1) to promote uniformity in legislation affecting insurance, (2) to encourage uniformity in departmental rulings under the insurance laws of the several states, (3) to disseminate information of value to insurance supervisory officials in the performance of their duties, (4) to establish means to fully protect the interests of insurance policyholders, and (5) to preserve to the states and United States possessions the regulation of the business of insurance. To achieve these purposes, the NAIC utilizes an extensive committee/task force system and has permanent staff located in two offices. One of these is the Task Force on Products Liability, which I chair.

One of the fundamental strengths of coordinated state regulation is its ability to bring to bear the efforts, talents and drives of 50 state insurance departments on the various regulatory problems facing the insurance industry today. This approach fosters independent innovations and flexibility in the development and application of regulatory techniques. At the same time, the insurance business has some nationwide characteristics. Thus, it is essential that there be a compromise between appropriate uniformity and the innovative ability of the states to flexibly act in response to their own particular problems. the NAIC is an

effective forum for dealing with the regulatory concerns shared by all individual states and United States possessions.

The attached statement has been reviewed and approved by the membership of the NAIC. I will be happy to respond in writing to any additional questions your committee directs. Your courtesy in reviewing my remarks is appreciated.

Sincerely,

NED PRICE,
Chair, NAIC, Task Force on Products Liability.

STATEMENT OF HON. NED PRICE, MEMBER, ACTING CHAIRMAN—TEXAS STATE BOARD OF INSURANCE; DEAN, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS; AND CHAIR, NAIC TASK FORCE ON PRODUCTS LIABILITY INSURANCE

The involvement of the National Association of Insurance Commissioners (NAIC) with the issue of products liability insurance over the past few years, as well as the day-to-day experience of insurance regulators with this aspect of the insurance industry, uniquely qualifies insurance regulators to assess the feasibility of providing Federal tax incentives for self-insurance against product liability exposure. We have firsthand knowledge of what will and won't work—what is cost effective and what is not. Under these circumstances it is particularly alarming to find that the Senate Finance Committee and its members appear unaware of the progress made in state regulation of this line of business and the information developed by this progress. Some of the details of the NAIC's involvement in the issue of products liability insurance and the technical details of this line of insurance business are described in the additional sections of this statement. First, however, I would like to address S. 3049 introduced by Senators Culver and Nelson regarding federal tax incentives for self-insurance for products liability.

This bill is substantially similar to the proposal put forth in the Department of Commerce Options Paper dated April 6, 1978. As such, it permits set asides of pre-tax income to fund reserves for self-insurance against product claims and related costs. Initially it is important to recognize that not all small businesses can benefit from the system contemplated by this bill. The experience of the Texas Market Assistance Program (MAP) which is consistent with the experience of the MAP's in many other states, (discussed later in this statement), indicates that the businesses having difficulty placing their product liability insurance have less than a million dollars in annual sales and manufacture unusual and/or hazardous products. According to the analysis provided by the Department of Commerce in the Options Paper only 40 percent of small business might have the funds necessary to utilize the set aside of pre-tax income. The question that must follow this analysis is, "Does this 40 percent represent businesses that have the greatest need for a break in affordability of this insurance coverage?" This 40 percent figure was drawn from the National Federation of Independent Business survey conducted in 1977. As referenced by the Department of Commerce on page 13 of this report the survey concludes:

"Small firms already lack access to capital and establishment of such a nonproductive fund would exacerbate an existing serious problem. Therefore, proposals revolving about some type of product liability fund, e.g. tax deductions or credits to help compensate for the non-productive use of capital, are absolutely superfluous for small manufacturers."

It may be additionally helpful for the Committee to examine the entire discussion of pre-tax income reserves reported in this survey:

"A second proposal, apparently being "kicked about" in government circles, involves a type of self-insurance where specified sums would be set aside for use in payment of claims not covered by insurance, claims in excess of excess of limitations or to cover a large deductible. The questionnaire suggested such a contingency fund might range from $10,000 for very small manufacturers to $100,000 for larger small manufacturers.

"Not surprisingly, surveyed small firms threw cold water on the proposal. 42.8% of the respondents reported they could not establish such a fund and another 24.8% reported they could do so, but with difficulty. Only 5.9% indicated such a fund was readily possible with 8% already possessing a similar fund. The remainder were either undecided or did not respond.

"Among those reporting they could not establish such a fund, firms with gross receipts of $50,000 or less were three times less likely to respond affirmatively

than those with $1,000,000 or more in gross receipts. Yet only 10.5% of the latter size classification of firms indicate a capability to establish such a fund without difficulty."

This discussion from the NFIB survey, seems to indicate that the firms that could be assisted by the tax incentive proposal are not those that the Market Assistance Programs in the various states have determined need the relief that is contemplated.

Another effect of S. 3049 would be to remove capital from the insurance market. Although the Department of Commerce contemplates that by stimulating greater use of self-insurance, the demand for product liability insurance could be reduced and availability increased, thereby reducing costs; this may indeed not be effect. If it is the larger small businesses that will be affected by the proposal as is discussed above, and significant capital is removed from the insurance market, then the effect may be to limit the current market for products liability insurance—raising prices. Additionally if the amounts paid into the trust equal a year's product liability premium, how can the coverage be either unavailable or unaffordable. The coverage provided through the insurance mechanism is much greater than specific premium—which would be the total dollar amount available to pay claims through the tax incentive proposal.

The types of cost to be funded through such a mechanism must also be scrutinized. One of the highest costs for product liability insurers today is that of a defense. Small business without in-house counsel can expect to pay an additional 35 to 48¢ of defense cost for each dollar paid to compensate accident victims. Then there are other costs such as insurance expertise to develop the self-insurance program. A small fund that is not invested even with regular yearly contributions can be quickly depleted by such costs.

The claims to be paid by these funds must also be analyzed. If losses in the product liability line of insurance were small and spread over a period of time, self-insurance reserves might be a workable alternative to insurance. However, severity has been shown the major problem of product liability losses. If firms in the 1 million to 5 million gross annual sales category are setting aside small percentages of gross sales, it could take years to build a sufficient reserve to fund a single large claim.

Additionally, if these reserves are a small percentage of sales from relatively small firms, to what extent are consumers protected by this plan? What is the recourse of a consumer whose damages exceed the self-insurance reserve? Consumers are better protected by high limits of insurance afforded by a premium than by a simple set aside of premium.

In the standard insurance market consumers are also protected by the regulation of the insurance companies affording the coverage. Companies are regulated for solvency and the rights of the policyholder. Ultimately the claimants of those policyholders are further protected by guaranty funds. What protection for the consumer/claimant does the self-insurance reserve offer? The tax legislation under consideration ignores these substantial protections of state insurance regulation in proposing a self-insurance deduction from pre-tax income.

The bills further ignore both the impact on state revenues of diversion of capital from the regular insurance market and the reservation of insurance regulation to the states by the McCarren Ferguson Act. Federal legislation also does not recognize the role of the individual states' products liability Market Assistance Program (MAP) in obtaining coverage for small businesses. A small business can obtain a rejection from many companies that do not write products coverage. If this proposal is adopted and a MAP exists in the state where businesses take advantage of tax incentives, then they should use the MAP mechanism to obtain coverage before self-insurance is considered. The MAP Committee instituted in the individual states is a better "band-aid" approach with none of the disadvantages of fraud or abuse inherent in the tax proposals. With these comments let me now describe the role of the National Association of Insurance Commissioners (NAIC) in the product liability "crisis."

I. BACKGROUND

Rising costs have been causing problems for many liability insurance lines in recent years. The NAIC first recognized the potential for serious problems in the products liability insurance line in December, 1975. Work was immediately begun in early 1976 to gather information and conduct research projects on

products liability matters. After hearings by the Availability of Essential Insurance Subcommittee of the NAIC, a resolution was adopted creating a Products Liability Task Force in June of 1976. This Task Force was "to work with statistical agencies and all other interested parties in developing additional experience data on products liability insurance to assist in evaluating current and future pricing and marketing problems for this line of insurance."

The culmination of various hearings throughout 1976 lead to the adoption of numerous recommendations by the NAIC in December, 1976. Among these recommendations was a proposal that an advisory committee be appointed to work with Products Liability Task Force and, most importantly, a proposal that a residual market mechanism be established to assist manufacturers in obtaining products liability insurance. Throughout this process the NAIC has worked with other organizations and governmental units in expanding the scope of understanding regarding products liability problems.

In the preliminary "Briefing Report" of January 1, 1977, the Federal Interagency Task Force on Products Liability made the following observation about products liability problems.

"Our study does suggest that the so-called products liability 'crisis' is not a crisis in the sense that a large sector of industry cannot obtain product liability insurance or that the increased cost of such insurance has made a substantial impact on the price of many products. On the other hand it does seem clear that a number of smaller business are facing a difficult choice as to whether to go without product liability insurance or to purchase it at sharply increased premiums. This situation could become more severe in the future."

From the experience gained in our work on products liability matters, the NAIC would concur with the major thrust of this observation. In fact at a recent meeting of insurance commissioners from the South Central states which included Texas, four states (Colorado, New Mexico, Oklahoma, and Wyoming) reported no product liability problems and the other states in attendance (Arkansas, Kansas, Nebraska, Texas, and Missouri) reported little or slackening activity in their respective Market Assistance Programs (MAP) for products liability. However, although products liability problems have not reached "crisis" proportions at this time, there are significant problems confronting various small businesses regarding products liability insurance cost.

The NAIC recognizes the complexity of the products liability problems and the role of the insurance mechanism in that complexity. The dilemma in the insurance sector of the products liability problem is the balance of charging adequate rates for anticipated products liability claims while making products liability insurance available at affordable prices. If an insurance company does not charge an adequate rate for the losses anticipated from the manufacturer of a particular product, it endangers its own financial condition and that of its other policyholders which jeopardizes the recoveries of all potential products liability claimants.

However, we also recognize if an insurance company charges excessively high premiums for products liability insurance there is a danger that the manufacturing enterprise which it insures will be forced to cease its operations because it cannot afford to operate with such high insurance costs. Finding an appropirate balance between these two considerations is indeed a difficult task. In fact, this may well be impossible in some individual situations since an adequate but not excessive rate may be higher than a particular manufacturer's perceived level of affordability.

Let me now elaborate on some particular complexities of the products liability insurance mechanism. Since insurance commissioners are charged by law with the regulation of products liability insurance in their respective states, it is this aspect of the products liability problem which is most familiar to them. One of the fundamental characteristics of the products liability insurance problem is the tremendous uncertainty inherent in the products liability ratemaking process. It must be recognized that, by definition, insurance is a technique for dealing with uncertainty concerning loss. If manufacturers and busineses were able to know in advance the number and severity of losses they would sustain as a result of products liability claims, there would be no need for products liability insurance. Specific amounts could be set aside to pay for future losses out of the operating income and profits of the business enterprise. Since no one—including insurers—is capable of forseeing the future, there is a large amount of uncertainty associated with the seting aside of monies to pay eventual products liability claims.

The first step in predicting future products liability losses from current policy viding products liability coverage. More specifically, let me describe in this context, elements of credibility, loss development and trend for products liability losses.

A. Credibility

The first step in predicting future products liability losses from current policy obligations involves the collection of a sufficient body of past experience to guarantee an accurate prediction of future experience. The body of experience which usually serves as the basis for making future predictions is the number of claims which have been produced from a particular number of exposures, or product risks. If the number of exposures giving rise to claims is either small or unknown—as is often the case with respect to most product liability coverages—it will not be possible to make a "credible" prediction of future claims. "Credibility", then, is a technical term used to describe the reliability of a particular body of experience, or exposure base.

In the context of products liability rates, credibility poses a particular problem for meaningful rate calculations. Although there may be large numbers of product claims in the aggregate, the number of claims for a particular product classification may be small. It is estimated that there are 10,000 different kinds of household consumer products on the market today, more than 4,000 drug products on the market, and an unknown number of industrial products. The number of product risks—or exposure base—for each of these products may vary from a very small number to a very large number depending upon the type of product. Where the number of products is extremely small, it is difficult to make a "credible" prediction on the amount of losses which will be generated from products liability claims.

Even in the case of a product category which encompasses a large number of products, it is still often difficult to make an accurate prediction of future product liability claims. It may be possible, for example, to know the number of products a particular manufacturer puts on the market in a given year—and thus the number of product "exposures"—but it is often impossible to know how many products produced in prior years are still operational. Moreover, manufacturers are constantly modifying, changing or improving their products so that the premium collected for a given policy year apply to a variety of different products even though the product in question falls under single product classification.

B. Loss Development

After a specific body of loss experience has been collected, this loss experience is than "developed" to predict what all losses will be when all policy obligations have matured. As time passes and more claims are paid the estimate of total losses from all policy obligations becomes clearer. As in the case of credibility, however, loss development in the products liability field contains inherent problems.

Because products liability litigation usually involves complex legal issues, the period of time between initial notification of a products liability claim and final disposition of that claim may be quite lengthy. Initial loss reserves established to meet the final settled claim, therefore, are subject to considerable—or "runoff"—because of inflation and other factors. Thus, the uncertain "development" of products liability losses under previous policy obligations makes it difficult to establish proper rates for future policy obligations.

C. Trend

A third factor contributing to products liability ratemaking uncertainty problems is the element of trend. After identifying a "credible" body of experience and applying a loss development factor to this body of experience, the actuary attempts to predict and quantify various changes and forces in the future which will impact on loss experience. This calculation, or trend factor, is an index which measures change over time.

Over the past few years both the frequency and size of products liability claims have risen significantly. Just recently Mr. S. John Byington, Chairman of the Consumers Products Safety Commission, noted that more Americans are claiming injuries from defective products and winning large awards than ever before. This phenomenon, commonly labeled "social inflation", is generally recognized as a problem confronting our tort liability system in general. Along with this influx

in the number and amount of claims being filed there has been a continuing high rate of inflation associated with the goods and services for which insurance must pay. Furthermore, the legal standards of liability as determined by the courts are evolving, in some situations radically, to pose even greater uncertainty. These factors—social and economic inflation—have produced losses beyond actuarial expectations further intensifying the trending problem.

Despite the fact that social and economic inflation have had a significant impact on products liability rates, there is an additional factor which complicates the ratemaking process for products liability underwriters. The factor is the uncertainty produced by products with an unusually long life—products in the industrial machinery classification, for example. These products are a constant potential for a products liability claim because they continue to be used many years after they leave the hands of the manufacturer. Because it is difficult to translate this potential for loss into a specific mathematical formula, the products liability underwriter finds it difficult to properly "trend" losses on existing products liability obligations.

The service that insurance performs for society is to assume uncertainties in exchange for a fixed premium. This service indeed is vital to our socioeconomic system. It enables individuals and businesses to borrow capital and to operate efficiently by providing a cushion against potential casualties over which they have little or no control. More specifically, products liability insurance provides manufacturers and businesses security by protecting against potential products liability claims which may result from their manufacturing and business operations.

In providing this security to manufacturers, products liability insurers must cope with tremendous uncertainties. In the products liability insurance field uncertainties exist as to what injuries a product may cause during its useful life, what the useful life of a product may be, how long it may take to report a products liability claim, how much expenses will be incurred under our judicial system, how much inflation may occur before a claim is settled, what changes may occur in public attitudes regarding a manufacturers liability and, finally, what changes may occur in standards that may be applied in the future to products manufactured at the present time. It is amazing that our products liability insurance system, although not perfect, works as well as it does in the face of these immense uncertainties.

II. PRODUCTS LIABILITY INSURANCE PROBLEMS IN PERSPECTIVE

Up to now I have addressed most of my comments at identifying and explaining the complexity of the products liability problem in general, and products liability insurance problems in particular. I would now like to discuss a few of the reasons why I do not believe the products liability problems have reached "crisis" proportions to date.

A. *Total cost of insurance and affordability*

The first point I would like to make with regard to the overall seriousness of products liability insurance problems is that the cost of products liability insurance, on a aggregate basis, would appear to be quite reasonable. The most recent edition of Insurance Facts discloses that the total net premiums for "other liability" lines and for "commercial multiple peril" lines in 1975 was $6.2 billion. Although these figures include premiums for risks other than products liability, they do encompass the entire spectrum of products liability policies. On the other hand, the total sales receipts for all durable and nondurable goods manufactured in 1975 amounted to $692 billion. If the sum of the "other liability" and "commercial multiple peril" net premiums (6.2 billion) is divided by the total sales receipts for all durable and nondurable goods ($692 billion) manufactured in 1975, a premium-to-sales ratio of .89 percent is obtained.

On the basis of these figures—which are indeed conservative—it is difficult to contend that products liability insurance costs, on an aggregate basis, are excessive. They are far less than the burdens imposed on the same manufacturers by federal income taxes. Admittedly, products liability premiums for a particular manufacturer may run much higher than 1 percent. If we look at the overall macrocosmic picture of the products liability insurance market, however, a 1 percent cost for products liability insurance is indeed a modest amount. This fact must be kept in mind when evaluating proposed changes to the existing products liability insurance system. Although there may be isolated cases of serious afford-

ability problems which deserve individual treatments, it is very difficult to conclude that there is a broad affordability crisis at this time.

B. Rates and profitability

I would now like to place the question of products liability rates in the broader context of profitability for the property and liability insurance industry in general, and the "other liability" and "commercial multiple peril" lines in particular.

In its work on monitoring the profitability of the property and liability insurance industry the NAIC has determined that the average profit, or insurance operating income on sales, for the years 1971 through 1976 amounted to 2.2 percent of earned premiums. This figure represents profits adjusted for generally accepted accounting principles (GAAP) after taxes and includes investment income earned on loss reserves. A profit of 2.2 percent of premiums for the entire property and liability industry is certainly not excessive. Even if all rates were reduced to the point where profit levels were zero, the net effect of such a reduction would hardly be noticed by the insurance-buying public. Moreover, can any industry regulated on the federal level such as the petroleum, banking or trucking industries, claim a similar low level of profits for the years 1971 through 1976?

Furthermore, if the NAIC profitability figures are examined for those lines of insurance which encompass products liability, it is evident that the profits for these lines of insurance in the last three years have not been excessive. The average operating profits for the "commercial multiple peril" line during the years 1973 to 1975 were 4.7 percent, while the average operating profits for the "other liability" line during the same period were 1.4 percent. It must be remembered that there are other insurance risks encompassed by these two lines of insurance so that these figures do not specifically reflect profitability for products liability insurance policies. Nevertheless, all products liability insurance underwritten today falls into one of these two lines of insurance.

As a result, it is fair to say that the profits generated by rates for commercial multiple peril policies and general liability policies in the last years have not been excessive.

From this data on the profits of the insurance industry as a whole and the profits for general liability insurance and commercial multiple peril insurance in particular, it is clear that the insurance system is operating within reasonable bounds. As costs rise, rates have risen to keep pace and profits have been a very small part of rates.

In this context, I might note the effect of more stringent rate regulation would have on the marketing and costs of products liability. As long as our economy is premised on the free enterprise system, which sanctions the concept of a reasonable profit, the insurance system appears to be operating well within reasonable parameters, at least up to this point in time. On an overall basis, rate regulatory efforts to squeeze down the rates at best would only have a marginal impact on cost, and at worst could create the unavailability problem we now fear.

This is not to say there are no unjustified attempts for rate increase. To these the regulator must be alert. But even more important, as the insurance industry continues to grapple with the above discussed problems in pricing their product liability coverages, the state insurance regulators (whatever the nature of their rating law) will monitor the appropriateness and fairness of such techniques to assure continued reasonableness of rates charged.

C. Commercial setting

A final point which must be made about products liability insurance problems is that products liability insurance is written as a commercial line rather than a personal line of insurance. In other words, insurance coverage for products liability involves an insurer and an insured who is in the business of making a profit. The price which the insured must pay for the insurer to assume the risk of products liability claims from the insured's manufacturing operations at least in theory, is a matter to be decided in the business negotiation of two commercial entities.

There is a second aspect of the commercial setting of products liability insurance which needs to be recognized in the context of products liability insurance problems. That aspect is the tremendous amount of business judgement needed to establish products liability rates which are neither excessive nor inadequate.

More specifically, I am speaking of the practice of "a" rating monoline products liability policies. It is estimated by the Insurance Service Office (ISO) that approximately 25 percent to 30 percent of all product classifications in monoline policies are "a" rated. Because certain products—usually products with a high potential products liability claim—can be used in a variety of different contexts and can be influenced by numerous extraneous factors, a large amount of business judgement must be exercised in establishing the premium for all potential product liability claims for a particular "a" rated product.

Because the price of products liability insurance for "a" rated classification demands such a high amount of business judgement, insurance commissioners have traditionally refrained from exercising direct control over "a" rated products risks. Not only have commissioners felt that such business judgement was needed to arrive at a reasonable rate, but commissioners do not have the resources to closely scrutinize every facet of the decision-making process related to rated product classifications in each and every case. In Texas we take rate review a step further in reviewing all developed "a" rates to determine the reasonableness of the rate. But, even with this process, increases were and are inevitable.

III. NAIC RESPONSES TO THE PRODUCTS LIABILITY INSURANCE PROBLEM

As I noted earlier, the NAIC has been working on products liability insurance matters for the past two years. The result of these activities has been a number of specific actions and recommendations aimed at solving particular aspects of the insurance problem. I will now briefly describe the substance of these activities and recommendations to give you an idea of what the NAIC believes is an appropriate response to the products liability insurance problem as it exists today.

A. *Insurance availability*

Although the NAIC has not found that there is a widespread availability problem for products liability insurance, a number of small businesses have been threatened with cancellation or nonrenewal of their existing products liability insurance coverage. In order to provide insurance to such small businesses in those cases where insurance coverage is difficult to obtain, the NAIC recently adopted a recommendation that:

"* * * local industry placement committees, in the form generally set forth in section 3 of the advisory committee report of February 15, 1977, be established in the states where the commissioner determines such a committee to be necessary."

At the present time the states of Arkansas, California, Connecticut, Illinois, Kansas, Louisiana, Maine, Michigan, Missouri, Nebraska, New Hampshire, New Jersey, Ohio, Pennsylvania, Rhode Island, Texas, Virginia and Wisconsin have actually implemented a local industry placement committee as contemplated by the NAIC resolution. In addition, the states of Indiana, Iowa, Kentucky, Tennessee, and Washington have indicated a desire to establish their own local industry placement committees in the very near future. Furthermore, a "report form" for use by the several states to report their respective experiences as to the success of their individual local industry placement committees has been developed and the results of the first quarter in 1978 will soon be available. This report form monitors the progress and success of local industry placement committees in making products liability insurance available on a voluntary basis to those small businesses who are finding it difficult to obtain or renew their products liability insurance coverage.

The NAIC firmly believes that these voluntary local industry placement committees are the best approach to addressing products liability insurance availability at this time. Preliminary results from the states indicate that local placement committees are a viable answer to the short-term availability problems of small manufacturers. The major advantage of this approach is that it enables small businesses to seek help in obtaining products liability insurance without massive state or federal government intervention into the private insurance market. The limited scope of the availability problem, the response of the NAIC with the placement committees and the preliminary experience of these committees demonstrate the lack of a current need for an inflexible mandatory residual market mechanism.

B. Insurance affordability

In adopting its recommendation that local industry placement committees be established in states where the commissioner determines a need exists, the NAIC recognizes that such committees address only the availability aspect of the products liability problem. The NAIC recognizes that long-term solutions to potential widespread insurance "affordability" problems in the products liability field can be achieved only by controlling or modifying factors which underlie high insurance costs. The concept is embodied in a recent recommendation of the NAIC that:

"* * * the most effective solution to the unavailability and high cost of products liability insurance is to control or modify factors which increase insurance costs and that, in the absence of credible data on the best approach to control such factors, the NAIC urges individual states to address and study the cost problem through all available means, including considerations or revisions in tort law, increased emphasis on safety engineering, more predictable rating techniques and the transfer of funds between insurance companies by way of subrogation, indemnification or contribution."

By adopting this recommendation the NAIC understood that insurance affordability in the products liability field cannot be solved by one single approach.

Rather, all factors which produce high insurance costs must be addressed before meaningful cost reductions can be achieved.

Provisions in tort law is one element recognized in the foregoing recommendation as a factor to consider in reducing insurance costs. Bills have recently been introduced in at least 33 states which deal with revisions in tort law in the products liability field. The NAIC believes that it is the role of the individual states to weigh the merits of various tort reform proposals to ensure a proper balance between the rights of claimants to recover for product-related injuries and the rights of manufacturers to be free from unreasonable products liability awards.

C. Data collection

In addition to addressing the problems of insurance availability and insurance affordability, the NAIC has been working to collect reliable data on the nature and scope of the products liability problem. I will now briefly describe four general areas of data collection which have been addressed by the NAIC.

1. NAIC Annual Statement

As you know, Mr. Chairman, insurance companies are required to file an annual statement in each state in which it is licensed to do business. Information on this annual statement is used to evaluate the financial condition and solvency of insurance companies and is the basis for federal income taxes. Although detailed information is available on the premiums, losses, and expenses of specific lines of insurance, information is not separately available for products liability insurance. At the present time, products liability information on the annual statement is included under the headings of "other liability" and "commercial multiple peril" along with information about other coverage sold to products manufacturers and other commercial buyers of insurance.

The annual statement shows the magnitude of each line of business, the profits or losses on each line and extensive detail on loss reserve adequacy. This data shows that the kinds of insurance purchased by manufacturers have, in general, not been excessively priced or over-reserved. Both the profits and the loss reserves are evaluated each year in the NAIC early warning reports, profitability reports, and report on profitability by line and by state.

Although products liability is generally marketed as a package with other coverages, advances in statistical reporting that are being put into effect by the Insurance Service Office (ISO) will require the separation of products data beginning with 1979. Thus, the NAIC recently amended the annual statement form to reflect products premiums and losses separately. This information covering 1979 will be reported in early 1980.

2. Statistical Plans

A second source of statistical data for products liability insurance is the statistical plans adopted by commissioners for use by the various insurance statistical organizations. These organizations collect data which are used by commissioners in regulating proper rates for property and liability coverage,

including products liability coverage. The Insurance Service Office (ISO), the National Association of Independent Insurers (NAII), the American Association of Insurance Services (AAIS) and the National Independenet Statistical Service (NISS) are the principal statistical organizations. This data has been collected and reported for over 30 years pursuant to a model rate regulatory bill adopted by the NAIC in 1946 and subsequently followed by almost every state.

The NAIC is following two approaches to obtain more reliable data for products liability insurance from the statistical plans of various statistical gathering organizations. First, the statistical gathering subcommittee of the NAIC has compiled a handbook which summarizes statistical data presently available for all lines of property-liability insurance, including products liability. This handbook is a useful starting point for discussing further improvements in statistical plans which encompass products liability experience. Secondly, as I mentioned earlier the NAIC has been working with the Insurance Services Office (ISO) in developing a new commercial statistical plan. This new plan will expand the body of information available for "a" rated products liability risks, provide new information on exposures and losses for commercial package policies and reduce some of the gaps presently existing for data reported under composite-rated policies.

Closed Claims Survey

The Insurance Service Office (ISO) conducted a closed claim survey of 23 major insurance companies which provide a majority of product liability insurance written in the U.S. The report covers a total of 24,452 survey forms for claims closed between July 1, 1976 and March 15, 1977. This survey provided valuable information in analyzing products liability issues and remedies. The following are some highlights from the survey:

1. Manufacturers account for 87% of the total claim dollars paid.

2. Food claims represent only 2% of the bodily injury payment although food products account for 56% of all paid products liability claims.

3. About 95% of the bodily injury payment and 89% of the property damage payments in products cases are covered by insurance.

4. Fewer than 1% of products liability bodily injury claims paid are responsible for more than 50% of the total bodily injury payments dollars. On the property damage side fewer than 1% of the paid claims account for more than 45% of the payment dollars.

5. More than two-thirds of the claims paid are far less than $1,000.

6. The average payment of bodily injury claims is $13,911 per claim against each defendant and $26,004 per incident. For property damage claim the average payment is $3,798 per claim and $6,871 per incident.

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7. The length of time before settlement of products liability claim may run several years. Claims involving 36% of ultimate bodily injury payment dollars and 33% of property damage payment dollars have not been processed four years after the first report of incident.

8. Workers injured on the job make up 11% of the products liability bodily injury claimants receiving payment, however, their claims make up 42% of the total bodily injury payments because their average payment is $97,884—much higher than the overall average.

9. Approximately 73% of bodily injury claims and 83% of property damage claims are settled without the filing of a law suit. Fewer than 4% go all the way to a court.

4. Questionnaires

Another source of information about the products liability insurance problem is a questionnaire survey of products liability insurers. The states of Kansas, Missouri and Nebraska developed products liability questionnaires over the past several years and have provided their respective state legislatures with information related to products liability insurance.

To avoid needless and expensive duplication of questionnaire surveys, the NAIC Task Force on Products Liability has developed a standard questionnaire form for use by the various states. This form addreses not only premium and loss information but marketing and underwriting as well. It has been sent out by Wisconsin and Texas to date. The Texas data has been collected and is now being analyzed.

5. Underwriting Case Studies

Much of the controversy surrounding the insurance aspects of the product liability "problem", has focused on the development of "a" or judgment rates for many types of business. The "a" rate denotes individualized evaluation of the hazards of a particular business or product risk and therefore development of "individual" rates. The subjective nature of this process has caused concern over possible overpricing of individual coverages.

The NAIC Task Force on Products Liability has directed the development of case histories of this individualized underwriting process so that the positive and negative aspects this process can be more completely understood.

Six underwriting case studies have been provided to the Task Force on Products Liability to illustrate the underwriting process. These case studies supplement the evaluation of underwriting and the need, if any, to limit this process of individual evaluation of risks.

The Task Force is continually evaluatiing all aspects of the products liability insurance "problem" to determine additional or revised regulatory action.

NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS,
Washington, D.C., September 8, 1978.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Senate Finance Committee, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The National Association of Wholesaler-Distributors wishes to present its views on S. 1611 and S. 3049, bills designed to assist businesses who are faced with severe problems regarding product liability.

The National Association of Wholesaler-Distributors (NAW) is a federation of 109 national commodity line associations which in turn are composed of over 40,000 merchant wholesaler and distributor establishments located throughout the 50 states. Wholesale distribution is a major force in the United States economy, with sales forecast by the U.S. Department of Commerce to reach over $600 billion this year.

Our members distribute virtually every conceivable type of consumer and industrial product. The product liability crisis is of major concern in the majority of these commodity lines, be they consumer products or industrial products.

The wholesale distribution industry is characterized by small, closely-held, family-owned businesses. In our own membership, the average sales volume is approximately $2.5 million, with an average of 25 employees. It is through this size of business that the vast bulk of products move to market. Net profits before taxes range from a low of one-half percent of sales to a high of four percent, with an average of about 1.7 percent. Thus, it can be readily seen that if the cost of product liability is as high as one percent, the impact on profits and financial stability is most significant.

Recent developments in product liability matters have created a crisis for all businesses. Wholesaler-distributors, because they are involved as legal sellers of the products involved in injuries, have not escaped. They are increasingly being directly impacted by product liability litigation as well as by the insurance industry's response to the losses which they are experiencing in the liability area. Our members have a vital interest in the growing impact of product liability on the continued viability of smaller business enterprises. We are particularly concerned about the following five problems:

1. The very rapid rise in insurance rates for both primary and umbrella coverage in products liability;
2. The increased unavailability of protective insurance covering product liability;
3. The exposure to liability without any proved negligence on the part of the wholesaler-distributor;
4. The exposure to suits of such a high magnitude that any one of them could bankrupt a small business;
5. The inability to properly defend ourselves in a court of law due to current legal doctrines.

Of particular concern is the trend towards increased unavailability of product liability insurance. An ever-increasing number of wholesaler-distributors have difficulty obtaining renewals of their policies, and when cancelled, find it almost impossible to obtain coverage from any other source. The inevitable result of this situation is that an increasing number of wholesaler-distributors have been forced to go "bare-bones"—with no coverage at all. In these instances, one loss could completely wipe out the firm.

We wish to express support for the provisions contained in S. 1611 and S. 3049. The major thrust of these bills is to provide a reserve fund for businesses faced with severe problems of product liability. Many of our members who cannot obtain adequate insurance protection would be materially assisted by such a provision in the tax code.

We note with interest that the Treasury Department's witness stated that self insurance was inherently inefficient, because "the insured party is required to put up $1 of capital for every dollar of risk insured." That is true. Business enterprises that are able to obtain adequate product liability protection would not find this a prudent use of capital. Unfortunately, too many firms find that current product liability protection is often unavailable, and the exemptions are extremely high even when available, meaning that self-insurance is forced upon many businesses. For the Treasury to oppose the product liability claim reserve on these grounds is to ignore the current situation regarding the availability of product liability insurance protection.

We do support the Administration's recommendation that the tax laws be amended to permit loss carryback for ten years instead of the current three year limit. This proposal will provide a small reservoir of capital to pay off a product liability claim. However, the businessman who has a product liability claim must be down to zero profit for that year, the year the product liability loss is sustained, before he can carry any loss to back years. Is the Administration stating that there can be no aid at all for a firm that cannot obtain product liability insurance until the firm reaches the zero profit position? Such is the end result of the Administration's proposed tax remedy for the current product liability situation.

We support the concepts of S. 1611 and S. 3049 that would permit a business to establish in a product liability reserve account, funds equal to three percent of annual sales, up to a maximum of fifteen percent of annual sales. The bills provide sensible and reasonable safeguards to prevent this reserve from being used for other purposes than the settlement of product liability losses.

Some questions have been raised as to whether the tax laws are more favorable to the treatment of insurance premiums than they are to self-insurance. Under current law, the cost of premiums for product liability insurance is fully tax deductible, while a reserve for such losses is not deductible. For the businessman who needs the product liability insurance protection, the discrimination is real, even though in the view of the Treasury Department it is evenhanded. The Treasury is considering the tax laws as they apply to insurance companies. We can view the impact only from the position of the merchant wholesalers. For the wholesalers who are able to obtain insurance, as many are, the premium is fully deductible. For the merchant wholesalers who cannot obtain insurance, the reserve must come from after-tax dollars. The bills under consideration would place those who cannot deduct their own reserve funds on a footing equal to those who can now do so through an insurance company.

We would like to note that the allowed reserve for product liability would not reduce reliance on product liability insurance if it is obtainable even at high premium levels. The high cost of defense and the threat of high awards for cases lost can best be met through insurance. The provisions of S. 1611 and S. 3049 would serve only as a partial alleviation of the problem and would not be a true substitute for sound insurance protection. We do believe, however, that smaller businesses will be materially assisted if the concepts of the reserves as contained in these two bills were enacted.

We request that this statement be made part of the hearing record on these legislative proposals.

Respectfully,

WILLIAM C. MCCAMANT,
Executive Vice President.

STATEMENT OF ROBERT N. FLINT, VICE PRESIDENT AND COMPTROLLER, AMERICAN TELEPHONE & TELEGRAPH CO.

My name is Robert N. Flint. I am Vice President and Comptroller of American Telephone and Telegraph Company. I take this opportunity to present to the Subcommittee on Taxation and Debt Management of the Senate Finance Committee the Bell System's position on S. 3176.

While S. 3176 deals specifically with the tax treatment to be accorded contributions in aid of construction which regulated electric and gas utilities receive from nonshareholders, the issue is of concern also to the Bell System.

We receive contributions in aid of construction for diverse kinds of special facilities constructed or made available to specific customers in circumstances where the provision of such facilities would not otherwise be economically feasible. Historically, regulatory bodies have required such reimbursements to be credited against the cost of such special facilities on the books and for ratemaking purposes, so that the broad spectrum of customers does not bear the burden.

We also receive reimbursements from state, local or federal agencies for the cost of relocating or reconstructing telephone plant necessitated by street or highway widening or relocation. Here too, regulatory bodies have required that the reimbursements be credited to the specific plant accounts involved, both on the books of account and for ratemaking purposes. Utility customers thus do not bear the burden of these costs. By far, the bulk of our reimbursements is of this type.

In both the above situations, the income tax treatment of these amounts has followed the book and ratemaking treatment for over half a century. That is, they are not included in income, they reduce the cost basis of the facility, and no depreciation or investment tax credit is claimed on them.

Recently, the Internal Revenue Service through administrative action has sought to reverse long-standing judicial interpretation of the law governing treatment of contributions in aid of construction and reimbursement of costs of relocating or reconstructing utility plant necessitated by governmental road widening or relocation.

In 1975 the Service sought to tax contributions in aid of construction received by a water utility. Congress promptly moved in the Tax Reform Act of 1976 to reestablish the historical tax treatment of such contributions for water and sewage disposal utilities.

Testimony before this Subcommittee has indicated the Revenue Service has now sought to tax such contributions received by the electric and gas utilities. S. 3176 would simply confirm for the electric and gas utilities the long-standing exclusion of such amounts from gross income, and thus would produce no revenue loss to the government.

We believe that the historical treatment whereby such receipts by regulated public utilities are excludable from gross income is the proper method, and that the reasons supporting such treatment for over fifty years are still valid today. We are concerned, however, that adverse implications for the telephone industry might well arise if it is not included in the proposed Bill. Therefore, we strongly urge that S. 3176 be amended to include regulated telecommunications utilities.

STATEMENT OF THE NATIONAL SOCIETY OF PROFESSIONAL ENGINEERS

The National Society of Professional Engineers, a nonprofit organization representing nearly 80,000 individual members who are engaged in every aspect of engineering, appreciates this opportunity to present comments on S. 1611 and S. 3049, bills to provide a tax deduction for additions to a reserve for product liability losses.

NSPE strongly supports the enactment of legislation that will allow amounts to be set aside in a reserve to fund product liability losses. It seems inconsistent that a deduction is allowed for the payment of product liability insurance premiums but not for contributions to a self-insurance trust fund. However, we believe that S. 1611 or S. 3049 should expand their coverage. Both bills limit the deduction to "product" liability losses. We believe that the Committee should include a deduction for design professionals within the coverage of the legislation you have under consideration. To that end, we support S. 2864, a bill introduced by Senator Charles McC. Mathias, Jr.

The liability problems of product manufacturers have justifiably become a matter of congressional concern, and we are convinced that an examination of the facts will show the liability problems of design professional warrant equal attention. Every product and every building or structure created must first be designed. In the product field, this is often done by the manufacturer's personnel. In the area of buildings and structures, however, the design is usually done by independent professional design firms. And just as product manufacturers have experienced stunning increases in the cost of liability coverage, so too has this group of design professionals.

THE PROBLEM

During the 1960's, professional liability insurance for building designers generally cost less than one percent of a firm's gross receipts. Because of its manageable cost and ready availability, purchased insurance became widely accepted by architects, engineers (A–E's) and their clients. In the 1970's, however, insurance premiums for this coverage began to skyrocket, with annual increases of 100 percent or more not uncommon. Actual increases, of course, vary by firm and state, but our studies indicate that average premiums for engineering firms have risen 577 percent over the past eight years. Liability coverage now represents an average of 3 to 10 percent of a design firm's gross receipts. For many A–E's, insurance coverage is now the largest single cost item after payroll. What is more, purchased insurance is generally a fixed cost for construction designers, while the construction industry is highly cyclical.

As significant as these premium increases have been, it is vitally important for this Subcommittee to understand they are but a part of the total liability cost problem faced by our members. Professional liability policies for A–E's are written with a deductible amount of first (investigation and defense) costs chargeable to the insured, that is applied to each claim. As premiums have escalated, many A–E firms have raised this deductible limit as the only way of controlling their costs. The deductible amounts now usually approach, equal, or exceed the annual premiums. This means that a design firm that does have one or more claims lodged against it in a single year can end up paying twice or three times the amount of the premium, even if none of the claims are successful. In addition to these cash expenses, the A–E firm must absorb the intangible costs of uncompensated professional time spent in investigation and defense preparation. Informed estimates indicate that a design professional spends three hours for every one hour an attorney spends in preparing to defend against a claim. Since an architect or engineer, as any professional, essentially sells his or her time, this can be a significant loss.

The importance of these uninsured first costs of liability payed by the designer over and above the premium is highlighted by two factual circumstances. First, the vast majority of claims against A–E's are relatively small property damage claims. From 1960 to 1976, 95.1 percent of the claims for which we have statistics did not exceed the deductible limits of policy coverage by more than $25,000. The average claim exceeded the deductible by $16,751 in 1976. The average deductible for that year ranged from $15,000 to $20,000 per claim. This indicates that the design professions are currently satisfying a substantial portion of the costs of liability out of pocket, even with insurance.

Second, the frequency of claims is increasing at the rate of 20 percent per year, so that now, 29.6 percent of insured architectural and engineering firms in our data base were sued in 1976. We simply live in a society that is ever more prone to litigation. In this connection, it should be pointed out that liability coverage for A–E's is written on a "claims made" basis. This means the insurance does not cover claims brought after a policy lapses based on acts or omissions committed during the term of the policy. So A–E's must maintain insurance, even after retirement or dissolution, for at least the length of the state's statute of limitations, if there is one.

All of this can be brought into sharper focus if put into the context of a hypothetical example: Let us assume a typical consulting architectural or engineering firm of 8 people carries $150,000 of insurance with a $10,000 deductible limit. The firm might be paying $8–12,000 per year in premiums for this, indicating roughly $200,000 in gross yearly receipts. Now assume that a dispute arises over a project involving responsibility for a construction delay and a claim is filed. In the same year, a tenant in an apartment house the firm designed five years earlier sues for damages due to water leakage in one of the apartments. The firm is now potentially facing $20,000 in direct, out of pocket expenses, after paying about $10,000

in premiums, before the insurance company has even incurred a loss, and before any finding of fault is made. In this all too typical example, 15 percent of the firm's gross receipts can be consumed or at least encumbered by professional liability just as a cost of doing business that year, the majority of it borne by the firm itself despite insurance. And it cannot be overemphasized that this is 15 percent of gross receipts, before payroll, rent, utilities, taxes, other insurance, etc.

IMPACT

To appreciate the effects of this recent, crippling, financial burden, it is important to recognize that the construction design profession is preponderantly one of small businesses. If we assume that there are about 10,000 full time architectural and engineering firms in the country, over 95 percent of all these firms qualify as small businesses under SBA's definition of that category.

Given this industry configuration, the impact of escalating liability costs is readily apparent. The increase in a firm's liability insurance premium often means the difference between laying off personnel and hiring new staff. A single claim can preclude expansion or the acquisition of more sophisticated design technologies, if not require a staff reduction.

The high cost of insurance has created a substantial barrier to the formation and expansion of new, small firms. The federal government and many states and local governments require liability insurance as a precondition to even qualify for a commission. And many if not most private clients require it as a contract condition. Therefore, because of the size of current professional liability insurance costs, a beginning architectural or engineering firm must be substantially capitalized before it can even compete for many commissions.

Of course the most important impact of the design profession's liability predicament is the risk it creates not only for architects and engineers but the public. When a single routine claim can bankrupt a small firm, and multiple claims can bankrupt a medium sized or even a large firm, where is the protection for the public? No profession practices with pristine perfection. Errors and omissions do occur and we carry insurance in recognition of that fact. But when this insurance is so costly as to be prohibitive for some firms and the liability exposure even with insurance is so great as to threaten the financial stability of the best practitioner, the just claimant may have no source of recovery. And it is not solely our clients who are exposed to this risk. Just as manufactured products enter the stream of commerce, the buildings and structures we design are used by the public to live and work in and travel on for decades. The design professional's liability exposure, and thus the public's risk and need for protection, is at least as great as that for manufactured products.

BEGINNINGS OF A REMEDY

Because of all the factors outlined above, we strongly urge the inclusion of construction design professionals within the coverage of the self-insurance tax bill before you. Senator Mathias' bill, S. 2864, with its many supporters, does include professionals. In the area of construction designers, we believe the ability to establish liability loss reserve account would be almost wholly used to cover exposure to first costs under insurance deductible limits. Because of the preponderantly small business nature of the profession and the high cost of the structures being designed, very, very few firms would or could attempt to totally self-insure. Virtually all architects and engineers who would elect to create a reserve account would do so in conjunction with purchased insurance to cover catastrophic losses. In fact, total self-insurance to the level of industry standards would be impossible under the Department of Commerce's draft bill, since that draft limits accumulation in a reserve account to a maximum of 15 percent of yearly gross receipts, whereas most A–E's carry insurance far above that percentage.

Design professionals currently are, in effect, self-insuring to an extent because of the limited nature of commercial insurance available. Existing tax law allows a deduction for purchased insurance premiums and actual uncompensated liability losses incurred. S. 2864 would simply allow a commensurate deduction for a reserve account to meet the same costs of doing business, but on a manageable more predictable basis. With a liability loss reserve account, an A–E firm could slowly build up a reserve to cover its exposure to the first costs of claims. As

the account grows, the firm could raise the deductible limit on its purchased insurance, thereby reducing or at least stabilizing premiums. The growth of the reserve would depend on the lack of claims, so these accounts would encourage and reward good performance much more than the current situation.

For new, small firms or sole practitioners just beginning, the ability to establish a reserve account would allow them to immediately set aside funds and gain some liability protection without having to wait until they can afford purchased insurance. And when a new practice does buy commercial coverage, a growing reserve account could help the firm get it cheaper. In this respect, should the Committee include designers in this bill, we would hope some language could be included in the report indicating the intent that amounts in these reserve accounts be considered on a par with commercial coverage in satisfying federal, and hopefully state, requirements for liability coverage in procurements.

We recognize there may be reluctance on the part of the Committee to extend coverage of liability loss reserve account legislation to all professions, since not all professions have similarly acute liability problems. Other professions have greater economic resources or greater institutional and legal protection from liability claims. But we strongly believe architects and engineers do have a problem so acute and a degree of exposure so great that coverage under the bill before you is warranted. Should you decide to allow construction designers the election option put forward in the Department of Commerce's draft bill, we offer the following suggested language to accomplish that end.

Amend section "(9)(A)" regarding the definition of product liability by inserting a colon after the phrase "or defects in" and amending the remaining portion of the section to read as follows—

"(1) A product manufactured, imported, distributed, leased, or sold by the taxpayer or, (2) the design, planning, evaluation, preparation of specifications, or administration of a contract by the taxpayer (whether in whole or in part) for the construction or modification of a building or structure on real property."

The inclusion of construction designers in the Department of Commerce's draft raises one other consideration relative to the penalty for withdrawals from the reserve account for other than liability purposes. Professional partnerships tend to be more fluid in their composition or practice specialty than manufacturing corporations and the construction industry is historically prone to more pronounced cycles of activity than the economy as a whole. In this context, there may be perfectly legitimate and sound business reasons for reducing the amount or altering the makeup of coverage. The draft bill would impose a very harsh penalty of one half of the amount withdrawn on such reductions. This could produce economic distortions and inhibit the proper use of these accounts.

For example, a firm specializing in one area may become the victim of another recession such as that experienced from 1973 to 1977 and have a substantial reduction in work. Knowing that over 90 percent of all claims against A-E's occur within four years of project completion and that future prospects are brighter in another area of specialization, a firm could logically decide to reduce its liability account gradually and use the withdrawals to retain and retrain staff personnel. In such a case, subjecting the withdrawals to ordinary tax rates plus a surcharge representing the value of the deferral would seem more appropriate than applying a 50 percent penalty.

Other than that one concern, we have no problems with the other restrictions in the Commerce Department draft designed to limit eligibility to small businesses. Our members are small businesses and would generally come within those restrictions. For example, the majority of our member firms would qualify as having a "severe liability insurance problem" now, and the maximum contribution limits are beyond the capability of all but a few firms.

Of course, any time a new deduction is proposed, the question of budget or revenue impact must be raised We have not heard of any accurate or reliable estimate being made at this point. All the estimates we know of either assume everyone eligible would establish a reserve account or do not discount the deductions already being taken. Intuitively, we believe extending the option of a liability loss reserve account to design professionals would not result in a significant revenue loss. Again, premiums and incurred uncompensated losses are already deductible. The revenue loss due to these existing business deductions would be absorbed or replaced by deductions for contributions to these accounts. To the extent that premiums for purchased insurance, that can now be deducted, are reduced, there may even be an offsetting revenue gain. We view liability loss

reserve accounts for architects and engineers not as some potential windfall for these professions but as recognition of the fact that designers must now self-insure their liability exposure to large extent. In that circumstance, reserve accounts would simply treat small professional firms on an equal basis with insurance companies.

We thank the Subcommittee for the opportunity to submit this statement.

STATEMENT OF LEE ANDERSON, PRESIDENT, ALEXANDER'S SPORTING GOODS, DANVILLE, ILL., ON BEHALF OF THE NATIONAL SPORTING GOODS ASSOCIATION

Mr. Chairman, I am Lee Anderson, President of Alexander's Sporting Goods, of Danville, Illinois. For 68 years Alexander's has been in the business of selling sporting goods at the retail level, as well as operating a team division, with three salesmen calling on High Schools and Universities. I am also the immediate past President of the National Sporting Goods Association, which represents dealers and manufacturers of all kinds of sporting goods.

Product liability has recently become a very great concern to everyone connected with sports in this country. Significantly, small and medium-sized businesses have been hardest hit by the burgeoning cost of insuring against product liability claims in the United States.

The product liability problem is rooted in changes in tort law developed by the courts over the last 18 years, in the absence of legislation. The courts have usurped the legislative function in this area, and it is now incumbent upon Congress to return a measure of balance to the law governing this complex subject.

It is my purpose today to speak in favor of S. 1611 and S. 3049, the bills being considered to amend the Internal Revenue Code of 1954 to provide a deduction for self-insurance for product liability. We also support the ten-year carryback proposal recently introduced by the Administration, but we stress that the carryback would prove useful only in combination with S. 1611 and S. 3049.

Before discussing the technical aspects of the proposals before this Subcommittee, I would like to call to the attention of the Subcommittee some of the conditions that a dealer and manufacturer of sporting goods faces on a daily basis.

The problem of not being able to obtain product liability insurance is faced by many dealers who sell trampolines, football equipment, skis and other high risk products. A manufacturer or dealer faced with this situation has the option of operating "naked" of insurance or joining an offshore insurance group. The first option could preclude satisfactory settlement of a just claim assuming that the assets of the dealer or manufacturer are not extensive.

The majority of sporting goods dealers in this country are small. Most have five or fewer employees. Life-long savings are often wrapped up in the dealership's assets, so that the dealer could literally lose it all because he does not have an insurance policy.

In addition, a small manufacturer with no insurance faces restricted sales. In our company we are very concerned about the insurance coverage of our suppliers.

The second option available to a manufacturer or dealer is to form or join an off-shore insurance group. Buying coverage by this method is more difficult for the dealer or manufacturer, and it also results in more dollars leaving the country.

The rising cost of product liability insurance is also becoming a factor in the cost of the product to the consumer. Dealers cannot absorb these costs, but must pass them on to the consumer in higher prices for the product. For example, a football helmet which cost $30.00 five years ago is $65.00 today.

School athletic programs, suffering from a lack of funds to start with, are also faced with the high cost of liability coverage. Fernade School District, near Eureka, California, which has only 250 students, paid $1,400 for liability coverage last year, and $9,200 this year. The cost of liability coverage for the Huntington Beach Union High School District rose from $83,000 two years ago to $250,000 this year. Many school districts are at the point of deciding to discontinue athletic programs because of the cost of insurance. Such a decision by many school districts would destroy the sporting goods industry, and America's youth would be the ultimate losers.

Therefore, I urge this Subcommittee to take action on the stop-gap provisions before it today, in order to allow American sports and the sporting goods indus-

try to survive while Congress devises a long-term solution to the product liability problem.

Turning, now, to the technical issues concerning the proposed legislation, NSGA supports the Administration's proposal to modify Section 172 of the Internal Revenue Code to provide a ten-year net operating loss carryback for losses attributable to product liability. Such a provision would help some businesses to avoid bankruptcy in the wake of a large product liability loss. For example, if an established, profitable company which has paid substantial amounts in federal tax during the previous ten years suffers a catastrophic loss, the carryback could provide a source of funds to enable the company to stay in business.

However, the proposed carryback alone is totally inadequate to meet the product liability insurance problem, even on a short-term basis. Accordingly, we feel that the Administration's position that the carryback would provide "all the benefits of a deductible reserve fund except deferral" is premised upon serious misconceptions regarding the nature and magnitude of the problem. Specifically, the carryback fails to address the following product liability-related needs of businesses:

1. Proof of Insurance Coverage.—Customers and suppliers of small businesses often refuse to deal with businesses which cannot show proof of product-liability insurance or a self-insurance reserve fund. Therefore, in order to remain in business, many companies which have never had a loss are forced to either pay exorbitant rates for commercial product liability insurance or fund a reserve entirely with after-tax dollars. Under present law, however, a business usually would elect the reserve fund method only if the commercial insurance premiums were at least twice the amount of the required annual contribution to a reserve, because contributions to the reserve are nondeductible. The businessman cannot satisfy his customers and suppliers with an explanation that he is "insured with the government" for 48% of any product-liability loss, as suggested by the Administration. That sort of "insurance" is highly dependent upon a record of profitable operation prior to the loss, and cannot be valued until the loss takes place. Therefore, the proposed carryback alone would do nothing at all to enable businesses which have never had a loss to demonstrate insurance coverage to their customers and suppliers.

2. Ability to Obtain Excess Coverage.—Commercial product liability insurance rates are much higher for "first-dollar" coverage (for example, the first $100,000 on a claim) than for "excess" coverage. If a firm can self-insure for first-dollar amounts, it can often obtain all the excess coverage needed at acceptable rates. However, in order to obtain commercial excess coverage, the firm is generally required to prove existing first-dollar coverage through another commercial policy or a funded reserve. The commercial insurer often will not sell excess coverage to a firm which merely decides to "go naked" or "be insured with the government" for the first-dollar amount. Therefore, the carryback alone would do nothing to enable businesses to obtain needed excess coverage.

3. Ability to Satisfy Claims Immediate.—The carryback provision would allow a firm subject to a product liability claim to obtain cash in the amount of the 48% of the claim for which he is "insured with the government" only after filing amended returns for the ten previous years and having claims for refund for those years processed by the Internal Revenue Service. The Administration has testified that a firm would be entitled to "immediate" refunds under the carryback scheme, but it did not indicate how much time might be required for filing and processing of amended returns before the "immedate" refund could be made. Any taxpayer knows that the Internal Revenue Service does not (and could not) hand him a refund "immediately" upon his completion of Form 1040. Similarly, refund proceeds resulting from carryback would not be available to a firm "immediately" upon its sustaining a product liability loss.

4. Ability to Use the Market to Reduce Commercial Insurance Rates.—Contrary to the Administration's portrayal of an "efficient" commercial insurance market, those who participate in that market know that its capacity falls far short of delivering the coverage needed by many businesses, especially small, high risk businesses. The high cost of product liability insurance, and the inability of some firms to purchase it at any price, result largely from a present lack of underwriting capacity in the insurance industry. The strain on that underwriting capacity could be eased substantially by a shift on the part of some firms to self-insurance, especially for first-dollar amounts. As the demand for product liability insurance decreased relative to the underwriting capacity in the insurance industry, the

cost of coverage to affected firms would drop considerably. However, the Administration proposal would do nothing to encourage self-insurance as an alternative to commercial insurance, and thus would not serve to lower commercial product liability insurance rates.

5. *Retention of Investment Credits and Other Tax Benefits.*—The usefulness of the carryback proposed by the Administration is dependent upon substantial tax liabilities for the years preceding the year of loss. Because other deductions and tax credits reduce the amounts of those liabilities, a firm which wished to be "insured with the government" would be forced to choose between, for example, the investment credit and product liability insurance. This aspect of the Administration proposal would result in serious disincentives to research and development and other undertakings which could have a positive long-term effect on the product liability problem in general.

6. *Claims on New or Marginal Businesses.*—Because the carryback provision would be useful only to firms which have made susbtantial tax payments during several prior years, it would be of litle or no benefit to new businesses or businesses which have operated marginally during the years preceding a product liability claim.

7. *Simplification.*—The requirement that a firm file amended returns for ten preceding years in order to receive the benefits of the carryback provision would add substantially to the complexity of the federal tax system for small businessmen.

Therefore, NSGA strongly urges the adoption of the self-insurance concepts embodied in S. 1611 and S. 3049 in addition to the ten-year carryback provision proposed by the Administration. Those self-insurance concepts would give small and medium-sized businesses the flexibility needed to protect themselves against product liability claims in the face of unobtainable or unaffordable commercial coverage. The provision of a deduction for contributions to a self-insurance reserve fund would eliminate the present tax law's discrimination in favor of commercial insurance. The primary manifestation of that discrimination is the "subsidy through deferral" which results from the current deductibility of insurance premiums, but which is denied with respect to contributions to a reserve fund. The Administration shows some inconsistency in stressing the magnitude of the benefit which such "subsidy through deferral" would confer on contributors to reserve funds, while at the same time denying that such a "subsidy through deferral" gives an economic advantage to commercial insurance policies.

The Administration has sought to demonstrate that, except for deferral, the present tax system treats self-insurers and purchasers of commercial insurance equally. However, close scrutiny reveals that equality of treatment results only where all of the following conditions exist:

1. The commercial insurance policy pays the claimant a much greater amount than the total cumulative amount of premiums paid;
2. The self-insurer is able to use all of his loss deduction; and
3. The self-insurer's loss is in an amount significantly greater than the amount accumulated in his reserve fund.

In all other situations, tax discrimination against self-insurance clearly does exist.

NSGA believes that contributions to a self-insurance reserve fund are entitled to the same deferral benefits as commercial insurance premiums. Although the Administration has criticized S. 1611 and S. 3049 on the ground that deferral benefits "high-bracket" corporate taxpayers more than "low-bracket" ones, the Administration statement concedes that almost all corporate taxpayers are in the same 48 percent "bracket". Another Administration criticism is that deferral carries the most benefit for those companies whose reserve fund contributions remain on deposit for the longest time; but we see nothing wrong with "rewarding" companies which go longer without a loss despite the fact that they are prepared for it.

Finally, the experience which our members have had with commercial product liability insurance in recent years leads us to believe that self-insurance could not be less "efficient", especially with respect to first-dollar coverage. Contrary to the assumptions underlying the Administration's position, the premiums for commercial coverage now available often bear little or no relation to the individual insured's actual experience. Needless to say, companies would choose commercial

insurance over a deductible reserve fund if they had reason to believe that the commercial insurance would be more "efficient."

In the end, the adoption of the concepts embodied in S. 1611 and S. 3049, together with the Administration's ten-year carryback proposal, is only a stop-gap measure which will ease the burden of product liability claims temporarily. Therefore, while we strongly urge immediate adoption of those proposals, we wish to emphasize the greater importance of developing a long-term solution to the product liability problem. Until Congress makes statutory changes in the tort law of product liability, manufacturers will continue to face the daily threat of extinction as a result of excessive product liability damage awards. The proposals which we endorse before this Subcommittee today will, however, help most manufacturers to continue operations in the face of that threat until a permanent solution is found.

Statement of James E. Weger, President of the Hauss-Helms Foundation, Inc., in Support of H.R. 4030

The Hauss-Helms Foundation, Inc. was established in 1965 by Mrs. Besse Hauss Helms and her husband, Walter B. Helms, for the purpose of aiding students in the Auglaize County-Allen County, Ohio area to continue their education past high school. Mrs. Helms was the majority shareholder of the Telephone Service Company of Wapakoneta, Ohio and at her death in 1967 she provided that, after certain income provisions for her husband, brother and sisters, her shares in that Company would belong to the Foundation. Mrs. Helms, although childless herself, had a keen interest in young people and a concern that they receive the education required to accept the challenge of our changing society. Mr. Helms shared this interest and concern and together they sought to have their personal wealth aid those who financial need made it impossible or impracticable to continue their education past high school. When Mr. Helms died in 1969 he left substantially all of his estate to the Foundation.

The Hauss-Helms Foundation, Inc. was determined to be exempt from Federal Income Tax as an organization described in Section 501(c)(3) of the Internal Revenue Code by letter from the Internal Revenue Service dated May 5, 1966. The grant procedures of the Foundation were approved in a letter from the Internal Revenue Service dated September 28, 1973.

The Hauss-Helms Foundation, Inc. was originally funded by a $5500.00 gift from Mr. and Mrs. Helms and its limited income during the years prior to the funding from the estates of Mr. and Mrs. Helms was used for scholarship grants to students in nurses training at St. Rita's Hospital, Lima, Ohio. However, beginning in the year 1970 scholarship grant payments have been made as follows:

Year	Amount
1970	$21,355.01
1971	66,619.34
1972	57,173.89
1973	76,870.42
1974	95,668.64
1975	105,642.34
1976	130,890.88

Today 118 young men and women are attending at 41 schools, universities and colleges with aid received from the Foundation.

The Foundation had total assets on December 31, 1977, valued in accordance with IRC provisions, of $1,943,100.68 and income for 1977 of $150.394.15. (7.7% return on year-end fair market value and 10.2% return on book value).

The Trustees of the Foundation, none of whom were related to Mr. and Mrs. Walter B. Helms, are as follows:

Name, office, and principal occupation:

James E. Weger, President and Trustee—Attorney at Law.

Vincent G. Hudson, Vice President and Trustee—President, Telephone Service Company.

Robert C. Lietz, Secretary & Trustee—President, The First National Bank of Wapakoneta, Ohio.

N. Thomas Cornell, Trustee—President, The Cornell Agency, Wapakoneta, Ohio.

Dr. John R. Haehn, Trustee—Optometrist, Wapakoneta, Ohio.

THE TELEPHONE SERVICE CO., WAPAKONETA, OHIO

The Telephone Service Company of Wapakoneta, Ohio is a corporation organized under the laws of Ohio and has as its sole business the operation of the Wapakoneta, Ohio and Cridersville, Ohio telephone exchanges under and subject to the rules and regulations established by the Public Utilities Commission of the State of Ohio.

The Company is managed by Vincent G. Hudson, its president, who has been employed by the Company for over twenty-six years. Mr. Hudson is assisted by Mr. Robert Brown, vice-president and general manager, and the Company employs 35 people.

The Board of Directors of the Company is made up of Mr. Hudson, James E. Weger and Richard L. Gebhardt. Mr. Hudson has been a director of the Company since 1952, Mr. Weger since 1955 and Mr. Gebhardt since 1962. The directors are paid an annual fee of $800.00. Mr. Gebhardt is a nephew of Mrs. Helms but owns no stock in the Telephone Service Company. He serves as Treasurer of the Company and receives a salary of $2400.00 per year therefor. His principal occupation and place of residence is in Dayton, Ohio.

On December 31, 1977, the Telephone Service Company had total assets of $4,140,847.25. The company has no debt other than current liabilities and on December 31, 1977 had $50,000.00 invested in short-term certificates of deposit. In 1977 the Company paid $464,391.93 in federal, state, and local taxes.

The Company has 8400 shares of common stock outstanding. It has but one class of stock. 4432 shares of the common stock are owned by The Hauss-Helms Foundation, Inc. There are no shares owned by any known relatives of Mr. and Mrs. Walter B. Helms, the creators of the Foundation.

Mrs. Besse Hauss-Helms, who was before her death the President of the Company for many years as well as the majority shareholder, saw the Company as community-oriented and dedicated to providing the best possible telephone service at the lowest possible rates. She never looked upon the Company as a source of her own enrichment. For many years, she served the Company as President without compensation and finally in 1952 she reluctantly accepted a salary of $3,000.00 per year. This was so even though she spent each work day at her desk at the Company office involved in the management affairs of the Company.

Mrs. Helms was aware that historically in our area when independent telephone companies merged or were acquired by the large telephone companies rates went up and service often deteriorated. She repeatedly rejected offers to purchase her controlling interest in the Company, regarding a sale to one of the larger telephone companies as detrimental to the community. Mrs. Helms saw The Hauss-Helms Foundation, Inc. as the answer to two of her vital interests:

(1) The Foundation would be the vehicle to provide assistance to young people in need of financial aid to continue their education past high school, and (2) to provide a safe harbor for the controlling interest in the Telephone Service Company thereby assuring the community of continued efficient telephone service at most reasonable rates.

The Telephone Service Company presently services 9,732 stations in its franchise area which has an estimated population of 15,000 persons. The Company has a reputation for low rates and excellent service. The Company has had but one rate increase since 1952. At the time of the last rate increase, effective January 1, 1975, the Public Utilities Commission of Ohio stated in its entry authorizing the increase:

"The applicant last received authority from this Commission for a general rate increase in 1952 (Case No. 22,956). Since that time it has continued to render service under tariffs which provide for local exchange rates which are among the lowest in this state, in most instances lower even than those authorized for mutual companies. For example, its present rate for one-party residential service is only $4.75 per month. Similarly, its installation and move charges of $1.00 and $1.50 are totally out of line with current industry practice. Even under its proposed tariff, these rates and charges would remain well below the statewide norm. (One-party residential service: $6.00; Installation charge: $4.00; Move charge: $4.00). However, despite these low rates, applicant, through efficient and economical management, has maintained quality service as reflected by a marked absence of subscriber complaints reported to the Commission."

The Telephone Service Company has continued to render efficient, economical telephone service to its subscribers since control has passed to the Foundation, and since 1972 the Company has paid in excess of 49% of its after-tax earnings to its shareholders.

One only need compare the monthly telephone rates of surrounding communities with those of Wapakoneta-Cridersville to see the startling economic benefits of this area served by the Telephone Service Company.

The Telephone Service Company monthly rate for a 1-party business phone is $9.00 and its monthly rate for a 1-party residential phone is $6.75. The Lima-Waynesfield franchise, which borders the Telephone Service Company franchise area on the north and east and is owned by United Telephone Company, has a monthly rate for a 1-party business phone of $35.60 and a monthly rate for a 1-party residential phone of $15.90. The Sidney franchise area, which borders the Telephone Service Company franchise area on the south and is also owned by United Telephone Company, has a monthly rate for a 1-party business phone of $25.30 and a monthly rate for a 1-party residential phone of $11.75. The St. Marys franchise area which borders the Telephone Service Company franchise area on the west and is owned by General Telephone Company, has a monthly rate for a 1-party business phone of $19.85 and a monthly rate for a 1-party residential phone of $10.00. We understand that both United Telephone Company and General Telephone Company presently have rate increase applications pending before the Public Utilities Commission of Ohio.

SECTION 4943, INTERNAL REVENUE CODE

This section imposes an excise tax on excess business holdings of any private foundation as those holdings are defined in the act. The initial tax and the additional tax imposed by the section are confiscatory in nature and if imposed would exceed the assets of The Hauss-Helms Foundation, Inc. The first phase of the correction period allowed by the statute expires on May 26, 1979 in the case of The Hauss-Helms Foundation, Inc. On that date the shareholdings of the Foundation and all disqualified persons in the Telephone Service Company must be reduced so as not to exceed 50% of the outstanding shares of the Company.

At the end of the next phase of the allowable correction period (15 years) the combined share holdings of the Foundation and disqualified persons must be reduced to not to exceed 20 percent of the outstanding shares of the Telephone Service Company.

The legislative history of Section 4943 IRC makes it clear that Congress was concerned about the use of a foundation to control business to the detriment of the foundation's charitable purpose and to the disadvantage of competing businesses. The abuses which Congress sought to prevent by the enactment of Section 4943 can be summarized as follows:

1. Use of the foundation to retain business control in the creator or the creator's family.
2. Use of the foundation's control of business to unfairly compete with other businesses whose owners do not have the advantage of tax-free income.
3. Diversion of the foundation's attention from its tax-exempt purpose to management of private business enterprises to the disadvantage of the chartiable purpose of the foundation.

None of the potential abuses which concerned Congress at the time it enacted Section 4943 IRC requiring divestiture of excess business holdings apply to The Hauss-Helms Foundation, Inc.'s ownership of controlling interest in Telephone Service Company:

1. None of the Trustees of the Foundation are members of creator's family or are remotely related to them.
2. One of the Trustees owns 10 shares of Telephone Service Company stock and one owns 3 shares. None of the three remaining Trustees own any shares of the company.
3. The Telephone Service Company is a publicly regulated monopoly within its franchise area and therefore does not compete against other businesses in its field. The Company pays its federal and state taxes as would any other corporate utility.

4. The Telephone Service Company operates independently from the Foundation and distributes in excess of 49 percent of its after-tax earnings in dividends to its shareholders.

For the community served by the Telephone Service Company to continue past May 26, 1979 to enjoy efficient telephone service at low costs the extension of the first phase of divestiture required by the provisions of Section 4943 must be granted by Congress, otherwise the Foundation must divest itself of the shares it owns in the Company for the highest price obtainable and we believe that price will require a sale to one of the larger telephone companies.

We did an informal rate survey of six former independent telephone companies in our immediate area which were acquired by large utilities during a period from 1945 through 1968. The survey revealed that telephone rates did indeed go up. The Lima, Sidney and St. Mary's franchise areas were all one-time independent companies and were included in the survey.

CONCLUSION

H.R. 4030, as originally drafted, provided that a Foundation in the position of The Hauss-Helms Foundation, Inc. would be required to reduce its stock ownership to 51 percent and no lower. By amendment on the Floor of the House of Representatives, the legislation was modified to provide an extension of the first phase of divestiture to 20 years from May 26, 1969. The Amendment removes the objections of the principal opponents of the measure and the legislation passed the House by a vote of 317 to 86.

The Amended Bill treats a foundation such as The Hauss-Helms Foundation, Inc. with less than 95 percent stock ownership of a corporation, the same as a Foundation with 95 percent or more stock ownership is treated by the current provisions of IRC Section 4943.

The Hauss-Helms Foundation, Inc. can effectively pursue its charitable purpose and at the same time aid the community served by the Telephone Service Company by the ownership of control of said Company.

Certainly the reasons for the enactment of Sections 4943 are not relevant to this situation.

The Foundation was created prior to the 1969 Tax Reform Act.

The stock owned by the Foundation in the Telephone Service Company was acquired solely by bequest.

No member of the governing body of the Foundation is a substantial contributor or a member of a substantial contributor's family.

The business of the Telephone Service Company is exactly of the same character as it was at the time of the first bequest of shares to the Foundation.

The Telephone Service Company has since 1972 distributed to its shareholders at least 49 percent of its income after taxes.

The Foundation distributes or uses all of its income for its tax-exempt purposes.

The Telephone Service Company does not own stock or shares in any other corporation.

The examination of the rate schedules of the Telephone Service Company and those of surrounding telephone franchises vividly establishes the economic benefit being realized by the community served by the Telephone Service Company, and although no such objective standards are available to illustrate the quality of service rendered by the Company, the absence of complaints to the Public Utilities Commission of Ohio is informative.

We believe the Telephone Service Company to be one of the most efficiently managed and operated telephone companies anywhere. We believe that the Company has been and continues to be community and service oriented. We believe that attitude is the result of the ownership of the controlling interest in the Company by The Hauss-Helms Foundation, Inc. We believe an economic disservice would be done to the approximately 15,000 people served by the Telephone Service Company if the Foundation is forced by law to divest itself of control of the Company.

The Trustees of The Hauss-Helms Foundation, Inc. are convinced that if reduction of ownership in the Telephone Service Company is required that they are under an affirmative duty to maximize the sales price of the shares by the sale of the controlling interest in the Company. The most obvious prospective purchasers

of the controlling interests would be the larger telephone companies. Both United Telephone Company and General Telephone Company franchises bordering the Telephone Company franchise area are on a banded rate schedule which permits automatic rate increases according to the number of stations served in the franchise area. If the Telephone Service Company were to be purchased by either Company and included in the banded rate schedule with permission of the Public Utilities Commission of Ohio, then depending upon which company acquired the Telephone Service Company, the increased cost to the subscribers in the Wapakoneta-Cridersville area could be from $300,000.00 to $600,000.00 each year.

Since 1970 when control of the Telephone Service Company was first effectively in the Foundation, there has been a demonstration that the charitable purposes of the Foundation have not suffered in their execution and accomplishment by reason of the ownership of the controlling interest in the Company. In that same period such ownership by the Foundation has probably saved more than a million dollars for area telephone subscribers.

At a time when all other utility charges are increasing dramatically, it is important that companies like the Telephone Service Company be permitted to continue efficient low cost phone service to those fortunate enough to live in its franchise area.

We ask that you recommend the adoption of H.R. 4030 which would extend the period for 10 years during which the Foundation can continue its ownership of controlling interest in the Telephone Service Company.

In the franchise area of the Telephone Service Company, you can still make a local call from a pay telephone for a nickel. The five-cent phone call, in this day of inflated prices, is a signpost that a utility can be profitable and service-motivated at the same time with resulting benefits to the people it serves.

Respectfully submitted,

JAMES E. WEGER,
President, The Hauss-Helms Foundation, Inc.

EXHIBIT A

MONTHLY TELEPHONE RATE COMPARISONS WITH SURROUNDING COMMUNITIES

Community	1 party business	1 party residential
Wapakoneta, Ohio (Telephone Service Co.)	$9.00	$6.75
Sidney, Ohio (United Telephone Co.)	25.30	11.75
St. Marys, Ohio (General Telephone Co.)	19.85	10.00
Lima, Ohio (United Telephone Co.)	35.60	15.90
Waynesfield, Ohio (United Telephone Co.)	35.60	15.90

EXHIBIT B

RATE SURVEY OF INDEPENDENT TELEPHONE COMPANIES ACQUIRED BY LARGE UTILITIES IN THE IMMEDIATE AREA

When small independent telephone companies were purchased by large telephone companies, the survey reveals that rates go up.

In our area the following telephone companies were purchased by large telephone companies and the 1-Party Business and Residential rates did indeed go up.

Independent franchise city and acquiring company	Rate before sale		Rate after sale		Present rate	
	Business	Residence	Business	Residence	Business	Residence
Kenton, Mid-Continent (1968)	6.00	4.25	8.00	6.50	26.90	12.50
Sidney, United Telephone of Ohio (1967)	5.50	3.75	8.25	5.75	25.30	11.75
Lima, United Telephone of Ohio (1967)	8.00	5.75	10.50	7.75	35.60	15.90
Waynesfield, United Telephone of Ohio (1967)	4.75	3.00	7.90	5.90	35.60	15.90
St. Marys, General Telephone Co (1953)	5.75	4.00	7.75	6.00	19.85	10.00
Celina, General Telephone Co (1945)	5.75	3.75	7.75	6.00	19.85	10.00

EXHIBIT C

TELEPHONE SERVICE CO., WAPAKONETA, OHIO—COMPARATIVE BALANCE SHEET, DEC. 31, 1977

	Balance	
	Dec. 31, 1976	Dec. 31, 1977
ASSETS		
Total fixed capital	$3,011,224.89	$3,270,770.86
Investments	500,000.00	650,000.00
Current assets:		
Cash on hand and in banks	30,955.40	34,205.99
Accounts receivable, subscribers	12,787.41	16,805.95
Due from subscribers, unbilled toll	86,288.62	96,551.29
Material and supplies	33,599.63	35,736.42
Total current assets	163,631.06	183,299.65
Prepayments	35,491.22	36,776.94
Total assets	3,710.347.17	4,140,847.45
LIABILITIES		
Common stock (8,400 shares PV $50)	420,000.00	420,000.00
Current liabilities:		
Accounts payable	21,793.98	33,009.86
Accrued taxes and other	16,957.84	61,663.16
Service billed in advance	3,496.92	4,566.33
Total current liabilities	42,248.74	99,239.35
Reserve for depreciation	1,037,456.10	1,188,255.77
SURPLUS		
Earned surplus	2,003,420.19	2,192,642.33
Income transferred to surplus	189,222.14	222,710.00
Capital surplus	18,000.00	18,000.00
Total surplus	2,210,642.33	2,433,352.33
Total liabilities	3,710,347.17	4,140,847.45

EXHIBIT D

TELEPHONE SERVICE CO., WAPAKONETA, OHIO—COMPARATIVE STATE OF INCOME, FOR THE YEAR ENDED DEC. 31, 1977

	Year	
Name of account	1976	1977
OPERATING REVENUE		
Subscriber station revenue	$531,203.97	$561,516.77
Miscellaneous operating revenue	34,791.33	40,746.42
Total local service revenue	565,995.30	602,263.19
Message toll revenue	809,503.38	927,176.80
Directory advertising	47,274.89	53,781.74
Uncollectible operating revenue	−4,500.07	−3,227.71
Total operating revenue	1,418,273.50	1,579,994.02
Operating expense	650,735.97	703,960.57
Net operating revenue	767,537.53	876,033.45
TAXES		
Taxes other than Federal income	110,153.30	131,406.13
Federal income tax	296,474.79	332,985.80
Total taxes	406,628.09	464,391.93
Net operating income	360,909.44	411,641.52
Other income	29,912.70	37,868.48
Income before dividend	390,822.14	4490,510.0

EXHIBIT E

TELEPHONE SERVICE CO., WAPAKONETA, OHIO—DIVIDENDS

Year	After-tax earnings per share	Dividend per share
1977	$53.51	$27
1976	46.52	24
1975	44.52	23
1974	34.47	18
1973	31.61	16
1972	28.89	12

STATEMENT OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Mr. Chairman and Members of the Subcommittee: The National Association of Regulatory Utility Commissioners, commonly known as the NARUC, supports S. 3176, which would amend section 118 of the Internal Revenue Code of 1954 to clarify the treatment of contributions in aid of construction to regulated electric or gas utilities.

The NARUC is a quasi-governmental nonprofit organization founded on March 5, 1889. Within its membership are the governmental agencies of the fifty States and of the District of Columbia, Puerto Rico and the Virgin Islands engaged in the regulation of utilities and carriers. Our chief objective is to serve the consumer interest by seeking to improve the quality and effectiveness of public regulation in America. In particular, those NARUC members responsible for the regulation of gas and electric rates within their respective States will be directly affected by S. 3176.

Historically, construction charges of regulated utilities in connection with the furnishing of new service have been treated as contributions in aid of construction and not included in the gross income of the utilities. This treatment is both logical and eminently fair since the cost of facilities necessary to serve new developments or the cost of governmentally mandated utility relocation should not be borne by existing ratepayers. The orderly development of utility services without adverse consequences to existing ratepayers has always been, and remains, a primary concern of this organization.

Many State regulatory commissions, sharing this concern, have approved developer contribution in aid of construction programs whereby developers either build or reimburse utilities for the cost of service extension into a new development. The commissions that have approved these plans do not permit the contributed plant to be included in the utilities' rate base and most do not permit any depreciation deduction to be made for ratemaking purposes. The ultimate beneficiary of the contribution in aid of construction programs has been the existing ratepayer who, because of the developer contribution and the tax treatment thereof, has not been required to pay increased rates in order to compensate the utility for its inability, in most situations, to realize a reasonable return on the cost of new facilities.

For many years, the Internal Revenue Service (IRS) has implicitly approved this tax treatment of contributions in aid of construction for all utilities. In 1958, in response to the decision of the United States Court of Appeals for the Third Circuit in the *Teleservice*[1] case, the IRS issued Revenue Ruling 58-555 (1958-2 C.B. 25) which expressly limited the policy to contributions made to regulated utilities.

Then, on December 4, 1975, the IRS issued what the NARUC considers an ill-founded opinion in Revenue Ruling 75-557 (1975-2 C.B. 33), holding that the connection charges of a water utility for furnishing a new service line and

[1] *Teleservice Company v. Commissioner of Internal Revenue*, 254 F.2d 105 (3rd Cir. 1958).

water meter constituted gross income to the utility. This ruling was based upon two recent court cases which the IRS felt were sufficient grounds for revoking Revenue Ruling 58-555.

In *United States* v. *Chicago, B. & Q.R. Co.*, 412 U.S. 401 (1973), the Supreme Court held that facilities constructed by a railroad, with government subsidies, at rail-highway grade crossings and at bridges to enhance the public safety were not depreciable assets under § 113(a)(8) of the Internal Revenue Code. The Supreme Court stated in that opinion that "Whether the governmental subsidies qualified as income to the railroad is an issue not raised in this case, and we intimate no opinion with respect to it." *Id.*, 412 U.S. at 408. Cited also in Rev. Rul. 75-557 is the case of *Hayutin* v. *Commissioner of Internal Revenue*, 508 F.2d 462 (10th Cir. 1975). The Court in that case, however, far from finding Rev. Rul. 58-555 invalid, specifically found that ruling inapplicable to the facts of that case since the payments received by the utility were not payments received for investment in facilities which were to be operated for an indefinite period of time. *Id.*, 508 F.2d at 480.

On January 30, 1976, the NARUC wrote to the Commissioner of Internal Revenue asking him to reconsider the ruling and to delay its implementation. In that letter the NARUC noted that ". . . home builders and developers have been the primary sources of funds contributed or advanced to the water companies to cover the costly connections required for new homes. In recent years, as is well known, it thas been both very difficult and very expensive to raise New Capital.

The contributions made by builders and developers have been important ingredients in ensuring that facilities will be constructed as needed, that present water-users will not bear the brunt—through general rate increases—of facilities installed for new users, and that the costs for constructing new homes will be kept as low as possible. Treating these contributions as gross income to the companies can only result in increased utility rates and increased costs for new houses, results which clearly should be avoided given the state of our economy and the home building industry in particular."

Subsequently, the NARUC Executive Committee adopted a resolution at its Winter Meeting on February 26, 1976, urging IRS to reconsider the ruling ". . . and to affirmatively determine that revenue contributions in aid of construction to utilities are not taxable income to the utilities provided the contribution is not includable in the utilities' rate base or depreciable for ratemaking purposes." NARUC Bulletin No. 10-1976, p. 25.

On April 5, 1976, the NARUC General Counsel sent a letter to the Chairman of each commission, urging him to write IRS at his earliest convenience to express his concern about the impact the ruling would have on the public utility industries, consumer rates, and construction costs. Many State commissions wrote to the IRS, urging it to revoke Rev. Rul. 75-557. The IRS, however, made no changes to the Ruling.

On April 19 1976, NARUC President Kelly wrote to Chairman Russell B. Long of the Committee on Finance, urging Congress to clarify the tax law to provide that contribution in aid of construction made to utilities be treated as contributions to capital.

In June, the Senate Committee voted to amend the tax laws to provide that contributions in aid of construction to water and sewerage utilities shall be treated as contributions to capital. This amendment was incorporated as Section 1322 of H.R. 10612.

Further hearings on H.R. 10612 were held during the week of July 19, 1976. The NARUC presented a statement to the Committee which supported the aim of Section 1322, and urged the Committee to broaden its coverage to all regulated public utilities by adopting a NARUC proposed amendment.

The Senate-passed bill restricted the "contributions-to-capital" provision to water and sewerage utilities and the House-Senate Conference Committee retained that version. While there is no statement in House Conference Report 94-1515 (Sept. 13, 1976), pages 434-6, or Senate Report 94-938 (June 10, 1976), page 502, as to the precise reasons for limiting the amendment to water and sewerage companies, it is most likely that such a limitation was considered appropriate at the time since Revenue Ruling 75-557 applied only to such utilities. In fact. the Conference report admonishes that "no inference should be drawn as to the proper tax treatment of such items by companies which are not water or sewerage utilities."

The NARUC remains convinced that neither the *Chicago, B. & Q.R. Co.* case nor the *Hayutin* case mandate that the IRS treat contributions in aid of construction to regulated gas and electric utilities as gross income. And in light of the just-quoted language of Conference Report 94–1515, it cannot be argued that Congress intended such a result by negative implication in limiting its 1976 legislation to water and sewerage utilities. Nevertheless, we understand that the IRS is now, for the first time, espousing a belief that contributions to gas and electric utilities must be included in gross income.

The NARUC's position remains the same as it was in 1976. These contributions should not be treated as income to the utility and the utility should not be required to seek general rate increases from the State commissions in order to pass these costs on to the present ratepayers. Since the regulated utilities are often required to offer service to new customers, or are required to relocate lines for highway or mass transit projects, they have no choice but to construct or alter necessary facilities. There is no profit-motive involved in the construction itself and the present beneficiaries, logically, should pay the cost of the facilities. The new facilities are not included in the rate base of the utility except to the extent the contribution may be refunded in future years. The utility may not depreciate or take advantage of the investment tax credit in connection with the facility.

In this manner the beneficiaries of the new facilities pay the capital cost of making a service available. The resulting service, namely the provision of gas, electricity or water, is paid for under the system-wide rate schedule and the payments are taxed as income. The capital cost of providing this new service, however, is not subsidized by present consumers of utility services.

The NARUC believes this treatment is fair and necessary to the orderly functioning of State regulatory systems. It represents a logical demarcation between funds that are paid in exchange for service and funds that are paid as capital to make the service available. While this has been the historic understanding of the matter, the IRS's recent shift in policy makes Congressional Clarification necessary. Accordingly, we urge the subcommittee to act favorably on S. 3176.

[COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS LISTED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON AUGUST 28, 1978

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

AUGUST 25, 1978

U.S. GOVERNMENT PRINTING OFFICE

32-712 O WASHINGTON : 1978 JCS-35-78

CONTENTS

	Page
I. Introduction	1
II. Summary	1
III. Description of bills	3
1. H.R. 810 (Mr. Conable): Permit private foundations to pay or reimburse Government officials for expenditures (up to certain limits) incurred for travel outside the United States	3
2. H.R. 4030 (Mr. Guyer): Increase the period during which certain private foundations may continue to hold their May 26, 1969, interests in certain public utilities without being subject to the excise tax on excess business holdings	4
3. H.R. 5099 (Mr. Moorehead): Relief of Brian Hall and Vera W. Hall to make them eligible for nonrecognition of gain treatment under section 1034 of the Code on the reinvestment of the proceeds of sale of their personal residence	6
4. S. 2771 (Senator Hathaway): Exempt from tax on unrelated business income the proceeds from the operation of certain games	7
5. S. 1611 (Senator Culver): Deduction for amounts placed in a reserve for product liability losses, and S. 3049 (Senators Culver and Nelson): Deduction for amounts placed in a reserve for product liability losses and for amounts paid to captive insurers	9
6. S. 3176 (Senator Laxalt): Allow public utilities to exclude from gross income, as contributions to capital, amounts received in aid or construction of electrical energy, steam, or gas facilities	12
7. S. 3345 (Senator Nelson): Amend the tax treatment of small business investment companies	14
8. S. 3441 (Senator Morgan): "The Independent Local Newspaper Act of 1978"	16

I. INTRODUCTION

The bills described in this pamphlet have been scheduled for a hearing on August 28, 1978, by the Subcommittee on Taxation and Debt Management of the Committee on Finance. The bills include 3 bills which have passed the House of Representatives. One of these bills, H.R. 810, was previously listed for hearing on June 19, 1978.

The pamphlet first briefly summarizes the bills, in the order in which the bills were listed in the press release announcing the hearings. This is followed by a discussion of each bill, setting forth present law, the issue involved, an explanation of what the bill would do, the bill's effective date, the revenue effect of the bill, any prior Congressional consideration of the bill, and the position of the Treasury Department with respect to the bill. The sponsor or sponsors of each bill are listed in the table of contents.

II. SUMMARY

1. H.R. 810

Treatment of Payment or Reimbursement by Private Foundations for Expenses of Foreign Travel by Government Officials

Present law, in effect, prohibits any "self-dealing" between private foundations and "disqualified persons." Under these rules, any payment or reimbursement by a private foundation of expenses of government officials generally is classified as an act of self-dealing. However, a limited exception in existing law permits a private foundation to pay or reimburse certain expenses of government officials for travel solely within the United States.

The bill (H.R. 810) broadens this existing exception to permit a private foundation (other than a foundation supported by any one business enterprise, trade association, or labor organization) to pay or reimburse government officials for certain expenses of foreign travel under similar types of limitations as apply under current law in the case of expenses for domestic travel.

2. H.R. 4030

Excess Business Holdings of a Private Foundation in a Public Utility

This bill would permit a private foundation and its "disqualified persons" together to hold in excess of 50 percent of the stock of a public utility for an additional 10-year period, if certain requirements are met.

3. H.R. 5099

Relief of Brian Hall and Vera W. Hall

The bill would extend private relief to Mr. and Mrs. Brian Hall so that they would qualify for nonrecognition of the gain from sale of their principal residence.

4. S. 2771

Exemption for Income Received by Certain Tax-Exempt Organizations From Bingo and Similar Games

Under present law, most organizations which are generally exempt from Federal income taxes are subject to tax on their unrelated business taxable income.

S. 2771 would provide that most tax-exempt organizations (under sec. 501(a)) would not be subject to tax on income from bingo and similar games that are conducted in accordance with State and local law and not in competition with profit-making businesses, even though such games are regularly carried on with paid labor.

5. S. 1611 and S. 3049

Reserves for Product Liability Losses

Under present law, a deduction is not generally allowed in the current year for amounts set aside in a reserve to pay estimated future product liability claims. Instead, the taxpayer is allowed a deduction for the product liability claim in the year that it is determined he is liable to pay it.

The bills would allow a deduction in the current year for amounts set aside to meet future product liability claims. The amount of deduction would be subject to certain limitations, and rules are provided to help ensure that the funds set aside are used solely to satisfy product liability claims.

6. S. 3176

Contributions in Aid of Construction to Gas and Electric Utilities

The bill would treat certain contributions to regulated public gas and electric utilities in aid of construction as contributions to capital by nonshareholders and not as taxable income to the utility.

7. S. 3345

Deficiency Dividends for Regulated Investment Companies Which Are Small Business Investment Companies

Under present law, a mutual fund qualifying for conduit treatment must distribute 90 percent of its taxable income within its taxable year or, with certain limitations, within the 12-month period after the taxable year. No deficiency dividend procedure is provided with respect to distributions made after this period. The bill would provide a deficiency dividend procedure for mutual funds that are also small business investment companies.

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8. S. 3441

"The Independent Local Newspaper Act of 1978"

The bill would allow independent local newspapers to establish tax-exempt trust funds in order to pay the estate taxes of the owners of the paper. Contributions to the trust by the paper would generally be deductible in computing income tax, and interests in the trust would be exempt from the estate tax. In addition, the bill would provide an extended payment period for estate taxes attributable to interests in independent local newspapers.

III. DESCRIPTION OF BILLS

1. H.R. 810

Treatment of Payment or Reimbursement by Private Foundations for Expenses of Foreign Travel by Government Officials

Present law

The Tax Reform Act of 1969 added a provision to the Code (sec. 4941) which in effect prohibits "self-dealing" acts between private foundations and certain designated classes of persons (referred to as "disqualified persons") by imposing a graduated series of excise taxes on the self-dealer (and also on any foundation manager who willfully and knowingly engages in self-dealing acts). Under this provision, the payment or reimbursement by a private foundation of expenses of a government official generally is classified as an act of self-dealing (sec. 4941(d)(1)(F)).

A limited exception to this provision permits a private foundation to pay or reimburse certain expenses of government officials for travel solely within the United States (sec. 4941(d)(2)(G)(vii)). Under this exception, it is not an act of self-dealing for a private foundation to pay or reimburse a government official for actual transportation expenses, plus an amount for other traveling expenses not to exceed 1¼ times the maximum *per diem* allowed for like travel by Federal employees. However, no such private foundation payment or reimbursement to government officials is permitted for travel to or from a point outside the United States.

Issue

The issue is whether private foundations should be permitted to pay or reimburse government officials for expenses for foreign travel and, if so, under what circumstances.

Explanation of the bill

The bill provides that a private foundation does not engage in an act of self-dealing in paying or reimbursing certain expenses of government officials paid or incurred for travel between a point in the United States and a point outside the United States. The maximum amount which can be paid or reimbursed by a private foundation for any one trip by a government official is the sum of (1) the lesser of the actual

cost of the transportation involved or $2,500, plus (2) an amount for all other traveling expenses not in excess of 1¼ times the maximum amount payable under section 5702(a) of title 5, United States Code (relating to like travel by a U.S. Government employee) for a maximum of 4 days.[1]

The exception added by this bill is not available to a private foundation if more than one-half of the foundation's support (as defined in sec. 509(d)) is normally derived from any one business enterprise, any one trade association, or any one labor organization, whether such support takes the form of interest, dividends, other income, grants, or contributions.

Effective date

The bill would apply with respect to travel beginning after the date of enactment.

Revenue effect

It is estimated that this bill would not have any direct revenue effect.

Prior Congressional action

An identical bill (H.R. 2984, 94th Cong.) was passed by the House of Representatives by voice vote on May 18, 1976, but was not acted upon by the Senate Finance Committee or considered by the Senate.

Treasury position

The Treasury Department recommends that the bill should be amended to limit the permitted amount of reimbursable transportation expenses to the cost of the lowest coach or economy air fare charged by a commercial airline.

The recommended change would make the reimbursable amounts under the bill consistent with the limitation on deductions for attending foreign conventions under the Administration's 1978 tax program. The Treasury Department would not oppose the bill if this change were made.

2. H.R. 4030

Excess Business Holdings of a Private Foundation in a Public Utility

Present law

The Tax Reform Act of 1969 imposed an excise tax upon the excess business holdings of a private foundation (sec. 4943 of the Code). Generally, under the excess business holdings provisions, the combined ownership of a business by a private foundation and all disqualified persons cannot exceed 20 percent of the voting stock of the business (35 percent if other persons have effective control of the business).

The 1969 Act provided that, if a private foundation and disqualified persons together had holdings on May 26, 1969, in excess of the permitted amounts under the general rules, then those holdings could be retained if they consisted of not more than 50 percent of the business.

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[1] Under 5 U.S.C. 5702(a), in the case of travel outside the continental United States, the President or his designee has the authority to establish the maximum *per diem* allowance for the locality where the travel is performed. Currently, for example, 1¼ times the daily amount so established for travel expenses in London is $102.50, for travel in Paris, $100.00, and for travel in Tokyo, $110.00.

If the combined holdings exceeded 50 percent of the business on that date, then over a transitional period the combined holdings would have to be reduced to 50 percent (ultimately to 35 percent if the disqualified persons hold, in the aggregate, no more than 2 percent of the business; if they hold more than 2 percent, then the combined holdings may continue to be as much as 50 percent, of which the foundation itself may hold no more than 25 percent).

In the case of a private foundation owning more than 50 percent (but no more than 75 percent) of a business, the private foundation is given 10 years (ending on May 26, 1979) within which to reduce its holdings to 50 percent (or lower, as explained above). In the case of a private foundation owning more than 75 percent (but not more than 95 percent) of a business, the private foundation is given 15 years (ending on May 26, 1984) within which to reduce its ownership to 50 percent (or lower, as explained above). In the case of a private foundation owning more than 95 percent of a business, the private foundation is given 20 years (ending on May 26, 1989) within which to reduce its ownership to 50 percent (or lower, as explained above).

Issue

The issue is whether a private foundation and its disqualified persons together should be permitted to continue to hold more than a 50-percent interest in a public utility until May 26, 1989, where the public utility is regulated, is relatively small, is not directly managed by disqualified persons, distributes to its shareholders at least 40 percent of its aftertax earnings, and meets certain other requirements.

Explanation of the bill

The bill would provide an additional 10 years within which certain private foundations must dispose of excess business holdings in certain public utilities. In effect, the bill provides the normal 20-year transitional rule applicable to private foundations holding more than 95 percent of a business to holdings by certain private foundations in certain public utilities to which the normal 10-year or 15-year transitional rules would normally apply.

In order to qualify for the special exception for public utility stock, the following tests would have to met:

(1) the private foundation must have held on May 26, 1969, at least 50 percent of the voting stock of the public utility (for this purpose, stock held in a trust or decedent's estate created before May 27, 1969, is deemed held by the private foundation if the foundation is the primary or remainder beneficiary of the trust or estate);

(2) all of the public utility stock owned by the private foundation must have been acquired by gift, devise, or bequest;

(3) no officer, director, or trustee of the public utility can be a person who contributed stock to the private foundation or a member of the family of any person who gave, devised, or bequeathed any public utility stock to the foundation;

(4) the utility must have been a public utility on May 26, 1969;

(5) the utility's taxable income for the first taxable year ending after May 26, 1969, must have been less than $1,000,000;

(6) the utility must have distributed to its shareholders, in each of any 3 of the 5 years preceding the year of enactment and each year ending after the date of enactment, at least 40 percent of its net income (determined after Federal, State, and local taxes for that year); and

(7) the private foundation does not purchase any interest in the public utility after the date of enactment.

This bill is intended to apply to the holdings of the Hauss-Helms Foundation in the Telephone Service Company of Wapakoneta, Ohio.

Effective date

The bill would apply to taxable years ending after the date of enactment.

Revenue effect

It is estimated that this bill will not have any direct revenue effect.

Treasury position

The Treasury Department opposes this bill. The Treasury Department is opposed to creating special exceptions to the excess business holdings provisions on an *ad hoc* basis. Regardless of the nature of the business controlled by the foundation and its donor or donors, the mere existence of foundation control inevitably tends to direct the foundation's efforts to operating the business more profitably and thus to divert attention from the charitable purposes of the foundation.

3. H.R. 5099

Relief of Brian Hall and Vera W. Hall

Present law

Under present law, the entire amount of gain or loss realized on the sale or exchange of property generally is recognized. However, under a so-called "rollover" provision of the Code (sec. 1034), gain is not recognized on the sale or exchange of a taxpayer's principal residence if a new principal residence, at least equal in cost to the adjusted sales price (as defined in sec. 1034(b)) of the old residence, is purchased and used by the taxpayer as his or her principal residence within a period beginning 18 months before and ending 18 months after the date of the sale of the old residence. (If the taxpayer constructs the new residence and construction begins within 18 months after the sale of the old residence, the taxpayer has up to 24 months, rather than 18, after the sale of the old residence to construct and use the new residence as his principal residence.) The basis of the new residence then is reduced by the amount of gain not recognized on the sale of the old residence.

The 18- or 24-month periods are extended up to 4 years during periods when the taxpayer serves on extended active duty with the Armed Forces of the United States, but there are no other statutory provisions for extension of the time limits.

A similar "rollover" rule applies to property sold under threat or imminence of condemnation or otherwise converted involuntarily (sec. 1033). Generally, if a taxpayer acquires a new principal residence after the threat or imminence of condemnation of his old residence occurs,

he will recognize gain on the subsequent sale of his old residence only to the extent that the proceeds of the sale exceed the cost of his new residence. If the old residence is sold first, the taxpayer has up to 2 years after the close of the first taxable year in which he realizes any part of the gain from the sale to purchase a new residence and avoid recognition of gain. Moreover, the Internal Revenue Service is authorized to extend this 2-year period for reasonable cause.

On October 24, 1975, Mr. and Mrs. Hall purchased a new residence located in Laguna Beach, California. However, they had difficulty selling their previous residence, located in Glendale, California. The House Judiciary Committee stated in its report on the bill that this delay was due to the disruption to the area caused by the construction of the Glendale Freeway, located less than 200 yards from the Halls' old residence. The Halls finally sold their Glendale property on June 15, 1977. However, the statutory 18-month period for the nonrecognition of gain on the sale of the old residence had expired on April 24, 1977. The 24-month period for rollover of the gain, which takes delays in construction of a new residence into account, was unavailable to the Halls. Because their old residence was not sold under threat or imminence of condemnation, they could not take advantage of the different rollover timing rules of section 1033.

Issue

The issue is whether the 18-month period (for nonrecognition of gain under sec. 1034) between the purchase of a taxpayer's new residence and the sale of his old residence should be extended for Mr. and Mrs. Hall.

Explanation of the bill

The bill provides that the Halls are to be deemed to have sold their residence in Glendale, California, within 18 months of the date of the purchase of their new residence at Laguna Beach, California, if they have in fact sold the residence in Glendale, California, not later than 6 months after the date of the enactment of the bill. Since the Glendale, California, residence was sold on June 15, 1977, the 18-month requirement of section 1034 would be met.

Effective date

The bill would take effect on the date of its enactment.

Revenue effect

It is estimated that the bill will have a negligible revenue effect.

Treasury position

The Treasury Department opposes this bill.

4. S. 2771

Exemption for Income Received by Certain Tax-Exempt Organizations From Bingo and Similar Games

Present law

Under present law, most organizations which are generally treated as tax-exempt under the Internal Revenue Code are nonetheless subject to tax on their unrelated business taxable income (sec. 511). Thus, un-

less a specific exception applies, an organization which is tax-exempt (under sec. 501(a))[1] is subject to tax with respect to income derived from any trade or business the conduct of which is not substantially related (aside from the need of the organization for income or funds) to the exercise or performance of its exempt function.

Under some State laws, nonprofit organizations are allowed to conduct bingo games or other similar types of games to raise funds for their exempt purposes. Often State laws limit the conduct of these types of games to nonprofit organizations.

Two recent cases have held that tax-exempt organizations are subject to unrelated business income tax on the proceeds of bingo games regularly carried on by the organizations with paid labor even though the organizations were not in competition with for-profit businesses.[2]

Issue

The primary issue is whether tax-exempt organizations should be subject to taxation on income from bingo and similar games that are conducted in accordance with State and local law and not in competition with profit-making businesses even though such games are regularly carried on with paid labor.

Explanation of the bill

This bill would exempt from taxation the proceeds of bingo and similar types of games in situations where State or local law permits such activities to be carried on by nonprofit organizations. This exemption from taxation would apply even though the activity is regularly carried on and is carried on with paid workers. However, to qualify for this exemption from the unrelated business income tax, the activity must not ordinarily be conducted on a commercial basis in the State in which the organization operates, and the conduct of the activity must not violate State or local law.

This bill would apply to games of the type in which usually the wagers are placed, the winners are determined, and the prizes are distributed in the presence of all persons placing wagers in the game. Thus, this bill would generally apply to bingo games, keno games, card games, dice games, and games involving wheels of chance, such as roulette wheels. (The statutory definition follows one of the exclusions from the term "lottery" under the wagering tax (sec. 4421(2)(A) of the Code).)

Effective date

This bill would apply to taxable years beginning after December 31, 1969.

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[1] In this pamphlet, references to "exempt organizations" do not include social clubs (sec. 501(c)(7)) and employees' beneficiary association (sec. 501(c)(9)), which may be taxable on investment income of all types as well as unrelated business income. The term "exempt organizations," as used also does not include political organizations (as described in sec. 527) and homeowners' associations (as described in sec. 528).

[2] *Clarence LaBelle Post No. 217* v. *United States*, —— F. 2d —— (8th Cir. 1978), 78-1 USTC ¶9496; *Smith-Dodd Businessman's Assn.*, 65 T.C. 620 (1975). In the *Smith-Dodd* case, a specific exemption for trades or businesses in which substantially all the work is performed without compensation (sec. 513(a)(1)) was held to be inapplicable because the organizations paid the workers $2 per hour and these sums could not be specifically correlated with the workers expenses. (The court indicated that expense reimbursement of workers might not violate the "without compensation" requirement.)

Revenue effect

It is estimated that this bill will reduce budget receipts by $15 to $20 million annually. This figure does not take into account the retroactive effective date which could increase the 1979 fiscal year revenue loss several times over this amount.

Treasury position

The Treasury Department would not oppose this bill if it were (1) limited to bingo and excluded other wagering games; (2) limited to areas where the conduct of bingo by exempt organizations is sanctioned by applicable State or local law and, under such law, bingo may not be conducted by profit-making enterprises; and (3) revised to make clear that, notwithstanding the exemption of such income from the unrelated business income tax, an organization still might jeopardize its exempt status if the extent of its bingo activities became excessive by comparison with its exempt activities. The Treasury Department also believes that it is inappropriate to extend this exemption to all organizations described in section 501(c).

5. S. 1611 and S. 3049

Reserve for Product Liability Losses

Present law

Under present law, taxpayers generally are not allowed to deduct estimated future expenses even though they may be related to current income. Specific exceptions to this rule presently provided in the Code include the deduction for bad debts on the reserve method (section 166(c)), accrual of amounts due to employees for vacation pay (section 463), and reserves of insurance companies to meet certain obligations to policyholders (subchapter L of the Code).

The general rule provides that deductions for expenses and losses may be claimed only when all events have occurred that fix the fact of the liability and the amount can be determined with reasonable accuracy (Treas. Reg. § 1.461-1(a)(2)). This is known as the "all events test." Under this test, deductions are not allowed for reserves for anticipated product liability losses because the losses have not occurred as of the close of the taxable year.[1] On the other hand, the losses are deductible in the year liability is fixed (either by settlement or judicial decree).

Under present law, taxpayers generally may claim a deduction for amounts paid to an insurance company to insure against anticipated losses, such as product liability losses. If a premium covers a period of more than 12 months, it is usually required to be prorated and deducted over the period of coverage. Losses covered by insurance are not deductible by a taxpayer, but losses in excess of insured amounts generally are deductible when the "all events test" has been met.

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[1] For a short period in 1954 and 1955, the Code provided a general rule (section 462) that allowed taxpayers to claim a tax deduction for certain anticipated expenses and losses related to current income. Among the items specifically covered by that provision were product guarantees and certain liabilities for self-insured injury and damage claims. The provision, along with its companion rule for income (section 452), was intended to conform tax accounting and financial accounting to a much greater extent than had ever been done before. Soon after enactment of the 1954 Code, it became apparent that the revenue loss from the two provisions would be much greater than originally anticipated. The two provisions were repealed in 1955, retroactive to their effective date.

Some taxpayers have established wholly owned subsidiary corporations whose business it is to insure against certain losses of the parent corporation and other members of the controlled group. These kinds of insurance companies are referred to as "captive insurance companies." The Service has taken the position (Revenue Ruling 77-316, I.R.B. 1977-35, 7) that premium payments to captives generally are not deductible because there has been no shifting of risk outside the controlled group. The Service argues that the premium payments amount to nothing more than a funding of a reserve that is normally not deductible.

Issues

Should a deduction be allowed for amounts set aside in a reserve to fund product liability losses? If a deduction is to be allowed, other issues that arise are: (1) Should product liability include liability for professional services, such as medical or lawyer malpractice? (2) Should the reserve be required to be placed in a trust (tax-exempt or otherwise) with penalties for premature withdrawals or improper use of funds? (3) Should limits be established on the amount that could be set aside and deducted in any single year and in the aggregate.

Explanation of the bills

S. 1611.—The bill would allow a deduction for limited amounts set aside in a trust fund to meet product liability losses. The product liability trust fund must be created or organized in the United States for the exclusive purpose of paying product liability losses sustained by the taxpayer. The trustee must be a bank or other person satisfactory to the Secretary of the Treasury. The earnings of the trust would be taxable, and its assets could not be commingled with other property except in a bank common trust fund.

The amount of deduction could not exceed 3 percent of the taxpayer's gross receipts for the taxable year from the activity that may give rise to the potential product liability. Further, the aggregate amount in the reserve could not exceed 15 percent of the average of the taxpayer's last 5 years' gross receipts from the activity that may give rise to the potential product liability. Product liability losses would not be deductible unless they exceeded the contributions to the account.

Improper use of account funds would cause the amount improperly used to be included in income, and, in addition, be subjected to a 50 percent penalty tax. In the case of a controlled group of taxpayers, each member of the controlled group (as specially defined in the bill) is to be treated as a separate taxpayer for purposes of determining the limitation on the deduction. The definition of product liability under the bill includes liability for personal injury or property damage arising out of the manufacture, importation, distribution, lease, sale or installation of products by the taxpayer.

S. 3049.—The bill would provide for a deduction for amounts contributed to a product liability trust and premiums paid to a captive insurer with respect to the product liability of the taxpayer. (It is not clear under the bill whether earnings retained in the trust would be taxable.) The product liability trust must be created or organized in the United States for the exclusive purpose of paying product liability losses sustained by the taxpayer. For this purpose, product liability losses include expenses incurred in the investigation, settlement and opposition of product liability claims.

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The trustee of the trust must be a bank or other person satisfactory to the Secretary of the Treasury. The assets of the trust could not be commingled with other property except in a bank common trust fund. The assets of the trust may not be invested in anything other than (1) public debt securities of the United States, (2) obligations of a state or local government which are not in default as to principal or interest, and (3) time or demand deposits in a bank or an insured credit union located in the United States.

The bill establishes limitations on the amount that may be deducted in any year with respect to any taxpayer. The amount of limitation depends on whether the taxpayer has a severe product liability insurance problem. A taxpayer is considered to have a severe product liability insurance problem for a taxable year if (1) he is unable to obtain a premium quotation for product liability insurance with coverage of up to $1 million, or (2) the lowest insurance premium quotation for such coverage is more than 3 percent of the taxpayer's gross receipts for the taxable year.

In the case of a taxpayer that has a severe product liability insurance problem, the annual deduction may not exceed 5 percent of the taxpayer's gross receipts for the taxable year from activities that may give rise to potential product liability. The aggregate amount in the trust may not exceed 15 percent of the average of the taxpayer's last five years' gross receipts from activities that may give rise to the potential product liability. In no event could the annual deduction exceed $100,000.

In the case of a taxpayer who does not have a severe product liability insurance problem, the annual deduction to the product liability trust may not exceed 2 percent of the taxpayer's gross receipts for the taxable year from activities that may give rise to potential product liability. Further, the aggregate amount in the trust could not exceed 10 percent of the average of the taxpayer's last 5 years' gross receipts from the activity giving rise to the potential product liability. In no event could the annual deduction exceed $25,000.

The bill makes it clear that a deduction will be allowed for premiums paid to a United States captive insurer, but that the premiums and contributions to a product liability trust would be aggregated for purposes of applying the limitations. In the case of a controlled group of taxpayers, only the gross receipts properly attributable to each member of the controlled group would be taken into account for purposes of determining the limitation on the deduction applicable to each separate member.

Product liability losses would not be deductible unless they exceeded the contributions to the trust. Improper use of account funds would cause the amount improperly used to be included in income, and, in addition, be subjected to a 50-percent penalty tax. The definition of product liability under the bill includes liability for personal injury or property damage arising out of the manufacture, importation, distribution, lease, sale or installation of products by the taxpayer.

Amounts accumulated in a taxpayer's product liability trust or captive insurer would be treated for purposes of the accumulated earnings tax as amounts accumulated for the reasonably anticipated needs of the taxpayer.

Effective date

Both S. 1611 and S. 3049 would be effective for taxable years beginning after December 31, 1977.

Revenue effect

S. 1611.—The revenue effect of this bill on budget receipts depends significantly on the rate by which companies elect under its provisions. If approximately ten percent of the eligible companies contribute one quarter of the eligible amount initially, and maintain the balance in later years, then the reduction of budget receipts is estimated to be $1.1 billion in 1979, $0.8 billion in 1980, and $0.7 billion in 1983.

S. 3049.—It is estimated that this bill will reduce budget receipts by $145 million in fiscal 1979, $110 million in 1980, and $24 million in 1983.

Treasury position

The Treasury Department opposes permitting a current deduction for contributions to a product liability trust under arrangements that result in tax deferral. Both S. 1611 and S. 3049 involved some elements of tax deferral and are therefore objectionable.

The Treasury Department believes that an appropriate tax response to the product liability problem is a long-term (10 years) net operating loss carryback for net operating losses attributable to product liability losses, an approach that does not result in tax deferral.

6. S. 3176

Contributions in Aid of Construction of Gas and Electric Utilities

Present law

In general

Generally, contributions to the capital of a corporation, whether or not contributed by a shareholder, are not includible in the gross income of the corporation (sec. 118). Nonshareholder contributions of property to the capital of a corporation have a zero basis to the corporation. If money is contributed by a nonshareholder, the basis of any property acquired with the money during the 12-month period beginning on the date the contribution is received, or of certain other property, is reduced by the amount of the contribution (sec. 362(c)).

Tax treatment prior to the Tax Reform Act of 1976

Early in the development of the Federal income tax laws, there were a number of court decisions which held that customer contributions to public utilities to pay for the costs of extension service lines were to be treated as contributions to capital, and not as income, of the public utility.

In 1958, the Internal Revenue Service announced that it would apply that early case law with respect to contributions to regulated utilities in aid of construction (Rev. Rul. 58-535, 1958-2 C.B. 25). In 1975, the Internal Revenue Service issued Rev. Rul. 75-557 (1975-2 C.B. 33) which revoked the 1958 ruling, withdrew the acquiescences in the early line of cases, and held that amounts paid by

the purchaser of a home in a new subdivision as a connection fee to obtain water service were includible in the utility's income. The ruling was made prospective for transactions entered into on or after February 1, 1976.

Tax Reform Act of 1976

Generally, the Tax Reform Act of 1976 provided that contributions in aid of construction to regulated public water and sewerage utilities (but not other utilities) are to be treated as nontaxable contributions to capital. However, nontaxable treatment was not provided for customer connection fees. Customer connection fees include payments made by a customer to the utility for the cost of installing the connection between the customer's property and the utility's main water or sewer lines (including the costs of meters and piping) and any amounts paid as service charges for stopping or starting service. In addition, the Act provided that a water or sewerage utility which received a nontaxable contribution in aid of construction was to receive no depreciation deductions or investment credit on property acquisitions attributable to the contribution.

The Act did not affect the treatment of contributions to utilities other than water and sewerage utilities.

Issue

The issue is whether contributions in aid of construction to regulated public gas and electric utilities should be treated as contributions to the capital of those utilities by nonshareholders or as taxable income to the utilities.

Explanation of the bill

The bill provides that contributions in aid of construction, received by gas and electric utilities, would be treated as contributions to capital by nonshareholders and not as taxable income to the utility. The bill would extend to these utilities the provisions applicable to water and sewerage utilities. Accordingly, similar taxable treatment would apply to customer connection fees. Also depreciation and investment tax credits would not be allowable for property acquired with the nontaxable contributions.

Effective date

The bill would apply to contributions made after January 31, 1976.

Revenue effect

If all the contributions in aid of construction were treated as income, the annual increase in tax liabilities is estimated to be in the range of $130–$200 million. This estimate takes into account the increases in the amounts the utilities would charge to their customers if all the contributions were treated as income to the utilities. It is uncertain when these tax liabilities would first be reflected in higher budget receipts, however. If the electric and gas utilities rely on past treatment and file tax returns as if Revenue Ruling 75–557 applied only to water and sewage companies, higher assessments of taxes against the electric and gas utilities probably would not occur until their 1976 tax returns are audited, probably some time during calendar year 1979. Some of these assessments undoubtedly would be contested in court,

but some might not. Thus, the first major impact on the budget receipts would very likely be in fiscal year 1980, but the timing of the higher tax payments and the amounts cannot be estimated by fiscal year with any degree of accuracy.

On the other hand, if Revenue Ruling 75-557 were limited to water and sewage utilities and does not apply to gas and electric utilities, and if court decisions would be in favor of the utilities, then the proposal to broaden section 2120 of Public Law 94-455 would have no revenue effect because it could be viewed as codifying the historic tax treatment of contributions in aid of construction of regulated public utilities.

Prior Congressional action

The provision relating to contributions in aid of construction for regulated public water and sewage utilities was added to the 1976 Act by the Senate Finance Committee. The Committee provision did not apply to gas and electric utilities. During the consideration of the 1976 Act on the Senate floor, an amendment was offered to include gas and electric utilities but the amendment was not adopted.

Treasury position

The Treasury Department opposes the bill.

7. S. 3345

Deficiency Dividends for Regulated Investment Companies Which Are Small Business Investment Companies

Present law

Under present law, a regulated investment company (commonly called a mutual fund) is generally treated as a conduit for income tax purposes. The taxable income of the company which is distributed to the investors each year is taxed to them without being subjected to a tax at the company's level. The company is subject to the corporate income tax on the income it retains. This treatment is accomplished by allowing a deduction to the company for its distributions to the investors.

A small business investment company is a company formed under the Small Business Investment Act of 1958 to furnish equity capital and long-term credit for small business concerns. These investment companies may qualify to be treated as regulated investment companies.

In order to qualify for conduit treatment, a company, including a small business investment company, must satisfy a number of requirements. Generally, the company must be a domestic corporation which is registered under the Investment Company Act of 1940 either as a management company or as a unit investment trust. In addition, a company must satisfy requirements relating to the portion of gross income which must consist of investment-type income, the portion of assets which must be represented by cash and securities, the portion of its income which must be distributed to the investors, and its stock ownership.

With respect to distributions, the company must distribute at least 90 percent of its taxable income, determined with certain modifications and without regard to the deduction for dividends paid, within its

taxable year or, with certain limitations, within the 12-month period after the taxable year (secs. 852(a) and 855). Unlike the treatment of real estate investment trusts, no deficiency dividend procedure is provided for a regulated investment company so that, under certain conditions, dividends paid after the taxable year and the following 12-month period may be taken into account for purposes of the 90-percent distribution requirement. Thus, a subsequent audit change by the Internal Revenue Service which increases income may cause the company to fail to meet the distribution requirement.

Issue

The issue is whether a regulated investment company which is also a small business investment company should be permitted to pay qualifying dividends after the expiration of the regular period for the payment of qualifying dividends.

Explanation of the bill

The bill would provide a deficiency dividend procedure for regulated investment companies that are also small business investment companies. The procedure would be available only for a small business investment company which is licensed under the Small Business Investment Act of 1958 and which qualifies and elects to be taxed as a regulated investment company.[1]

Under the procedure, the company could make qualifying distributions after the regular period for making distributions when an adjustment by the Internal Revenue Service occurs that either increases the amount which the corporation is required to distribute to meet the distribution requirement or decreases the amount of the dividends previously distributed for that year. This deficiency dividend procedure would be available only where the entire amount of the adjustment is not due to fraud with intent to evade tax or willful failure to file an income tax return.

Interest at the regular rate would be imposed on the amount of the deficiency dividend. In addition, a penalty equal to the interest charge would be imposed but the penalty could not exceed 50 percent of the deficiency dividend. The imposition of a penalty and interest is designed to discourage a company from reducing its current distributions of income in reliance on the availability of the deficiency dividend procedure to retain its qualified status.

The procedure is similar to the deficiency dividend procedure provided for real estate investment trusts by the Tax Reform Act of 1976.

The bill would benefit the Allied Investment Company of Washington, D.C. In addition, there are approximately 28 small business investment companies which have elected, or may elect, to be taxed as regulated investment companies and which might benefit from the bill.

Effective date

The bill would be effective for determinations occurring after the date of enactment.

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[1] The Federal Tax Division of the American Institute of Certified Public Accountants has recommended the adoption of a deficiency dividend procedure similar to that provided for real estate investment trusts for all regulated investment companies rather than just those companies which are also small business investment companies. Federal Tax Division of the American Institute of Certified Public Accountants, *Recommended Tax Law Changes* 69 (1977).

Revenue effect

It is estimated that enactment of this bill would reduce budget receipts by about $200,000 in fiscal year 1979 and by less than $500,000 annually thereafter.

Treasury position

The Treasury Department supports the bill and supports extension of the deficiency dividend procedure to all regulated investment companies. However, the Treasury believes that the bill in its present form should be amended in certain technical respects. In particular, the procedure should be conformed to that provided for real estate investment trusts by the Tax Reform Act of 1976. (See secs. 1601(b)-(f) of P.L. 94-455.)

8. S. 3441

"The Independent Local Newspapers Act of 1978"

Present law

With respect to a trust established for the purpose of paying estate taxes attributable to an interest in a business (including an independent local newspaper), no provision is presently made under the Code for (1) according tax-exempt status to such a trust, (2) allowing income tax deductions for payments to the trust, or (3) excluding the corpus of the trust from estate taxes.

The Code provides extended payment provisions with respect to the estate tax attributable to interests in closely held businesses (secs. 6166 and 6166A).[1]

In addition, provision is made for capital gain treatment of certain redemptions of closely held business stock where the redemption is for the purpose of paying estate taxes (sec. 303).[2]

Issues

The main issues are (1) whether the owner of an independent local newspaper should be permitted to establish a tax-exempt trust to pay estate taxes attributable to the value of his interest in the newspaper, (2) whether the funds contributed to the trust (within prescribed limits) should be deductible by the newspaper for income tax purposes, (3) whether the value of the trust assets should be excludable from the owner's taxable estate in computing estate taxes, and (4) whether

[1] Section 6166 provides a 15-year period for the payment of the estate tax attributable to the decedent's interests in a closely held business (including a farm). Under this provision, the executor can elect to defer principal payments for up to 5 years from the due date of the estate tax return. Thereafter, pursuant to the executor's initial election, the principal amount of the estate tax liability may be paid in from 2 to 10 installments. In order to qualify for this deferral and installment payment treatment, the value of the closely held business (or businesses) in the decedent's estate must exceed 65 percent of the value of the gross estate reduced by allowable expenses, indebtedness, and losses.

Section 6166A provides a 10-year extended payment of estate tax attributable to a closely held business where a lesser proportion of the estate is represented by its value. Under this 10-year extension, the value of the business must be in excess of either 35 percent of the value of the gross estate or 50 percent of the taxable estate.

[2] To qualify for this treatment, the value of the stock redeemed, plus the value of the other stock of the redeeming corporation includible in the estate, must be more than 50 percent of the "adjusted gross estate." The value of the stock redeemed can be no greater than the sum of all death taxes (and interest) plus funeral and administration expenses allowable as an estate tax deduction.

a 15-year period should be provided for the payment of any estate tax attributable to the value of an interest in the newspaper to the extent the tax was not paid by the trust.

Explanation of the bill

Under the bill, an independent local newspaper could establish a tax-exempt trust to receive payments to pay the estate tax liability of the owner of the newspaper. The newspaper would be allowed an income tax deduction in an amount not to exceed 50 percent of its taxable income for amounts paid to the trust. The trust assets would be required to be invested solely in obligations of the United States. The assets of the trust could be used only to pay the Federal estate taxes of the owner of the newspaper.

The trust would be limited to holding amounts necessary to pay the potential Federal estate tax liability of the newspaper owner. In determining this limitation, the potential estate tax liability of a living individual would be considered to be 70 percent (i.e., the maximum estate tax rate) of the value of his interest in the business. Under the bill, any interest of a decedent in the trust would generally not be included in the decedent's gross estate.

If the owners of a newspaper which has established a trust for their benefit dispose of their interest in the newspaper, the amounts in the trust must be distributed and included in the owners' income and the deduction previously allowed the newspaper would be recaptured.

An "independent local newspaper" is defined as a newspaper publication which is not a member of a chain of newspapers if it has all of its publishing offices in a single city, community or metropolitan area, or, as of October 31, 1977, within one State. A "chain of newspaper publications" is defined as two or more newspaper publications under common control on October 31, 1977, and which are not published in a single city, community, or metropolitan area.

Under the bill, payment of any estate tax attributable to the value of an independent local newspaper not paid by a trust established under the provisions of this bill could be extended for a period of up to 15 years. This provision would apply where the estate does not qualify under existing extended payment provisions of present law. (See secs. 6166 and 6166A.)

Under this extended payment provision, the executor could elect to defer principal payments for up to 5 years from the due date of the estate tax return. However, interest for the first five years, payable at the rate of 4 percent, would be payable annually. Thereafter, the principal amount of the estate tax liability could be paid in from 2 to 10 annual installments. If the business ceases to qualify as an independent local newspaper, the extension would terminate.

Effective date

The provisions of the bill would apply to estates of decendents dying after October 1, 1977.

Revenue effect

It is estimated that this bill will reduce budget receipts by $10 million annually.

Treasury position

The Treasury Department opposes this bill.

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