1981–82 MISCELLANEOUS TAX BILLS, XII

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

S. 1081, S. 1594, S. 1749, and S. 1764

NOVEMBER 6, 1981

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1981-82 MISCELLANEOUS TAX BILLS, XII

FRIDAY, NOVEMBER 6, 1981

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

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

Present: Senators Packwood, Chafee, Byrd, Long, Durenberger, and Symms.

[The committee press release announcing this hearing; the bills S. 1081, S. 1594, S. 1749, and S. 1764; the description of these bills by the Joint Committee on Taxation follow:]

[Press Release No. 81-172]

PRESS RELEASE

For immediate release, October 27, 1981,
Committee on Finance,
U.S. Senate,
Subcommittee on Taxation and Debt Management, 2227 Dirksen Senate Office Bldg.

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARINGS ON FOUR MISCELLANEOUS TAX BILLS

Senator Bob Packwood, Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance, announced today that the Subcommittee will hold a hearing on November 6, 1981, on four miscellaneous tax bills.

The hearing will begin at 9:30 a.m. in Room 2221 of the Dirksen Senate Office Building.

The following legislative proposals will be considered at the hearing:

S. 1081.—Introduced by Senator Mathias. S. 1081 would generally provide for a deduction for certain amounts paid into a reserve for service liability losses and expenses of design professionals.

S. 1594.—Introduced by Senator Symms. S. 1594 would provide that the civil fraud penalty only apply to that portion of an underpayment which is attributable to fraud.

S. 1749.—Introduced by Senator Chafee. S. 1749 would provide for the nondeductibility of any payment made to an official or employee of a foreign Government that would be unlawful under the Foreign Corrupt Practices Act of 1977.

S.1764.—Introduced by Senator Moynihan. S. 1764 would amend certain requirements relating to a definition of cooperative housing corporations.

DESCRIPTION OF TAX BILLS
(S. 1081, S. 1594, S. 1749, and S. 1764)

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on November 6, 1981, by the Senate Finance Subcommittee on Taxation and Debt Management.

There are four bills scheduled for the hearing: S. 1081 (relating to deduction for self-insurance set-asides for liabilities of design professionals), S. 1594 (relating to increase in civil fraud penalty and limitation of penalty to portion of underpayment that is attributable to fraud), S. 1749 (relating to deductability of payments under the Foreign Corrupt Practices Act), and S. 1764 (relating to definitions concerning cooperative housing corporations).

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of the bills, including present law, issues, explanation of provisions, effective dates, and estimated revenue effects.

I. SUMMARY

1. S. 1081—Senators Mathias, Long, Durenberger, Heinz, D'Amato, and Bentsen

Deduction for Self-insurance Set-asides for Liabilities of Design Professionals

Present law generally does not permit a taxpayer to deduct currently amounts set aside in a self-insurance fund or trust to satisfy contingent liabilities, such as future claims based on negligence or malpractice in furnishing services. Under the bill, architects, engineers, and other design professionals could elect to deduct currently amounts paid into a trust established by the taxpayer for the purpose of funding liabilities attributable to negligence or breach of warranty in the taxpayer's work. The deduction for any one year could not exceed $100,000 in the case of a taxpayer with a "severe service liability insurance problem" or $25,000 in the case of other eligible taxpayers.

Under present law, a trust established to provide funds to satisfy contingent liabilities generally does not qualify for tax-exempt status. The bill would provide that a self-insurance trust to which payments would be deductible would be exempt from income tax.

2. S. 1594—Senator Symms

Increase in Civil Fraud Penalty and Limitation of Penalty to Portion of Underpayment that is Attributable to Fraud

Present law imposes certain penalties on taxpayers who underpay taxes because of negligence or civil fraud (sec. 6653). The negligence penalty generally is 5 percent of any underpayment that is due, in whole or in part, to negligence or intentional disregard of rules or regulations but not with intent to defraud. The alternatve civil fraud penalty is 50 percent of any underpayment if any part of any underpayment is due to fraud.

The bill would provide that if any portion of an underpayment of tax is due to fraud, then there would be an addition to tax of an amount equal to 100 percent of that portion of the underpayment. The provision would be effective for additions to tax made after the date of enactment.

3. S. 1749—Senator Chafee

Deductibility of Payments Under the Foreign Corrupt Practices Act

Under present law (sec. 162(c)(1)), no deduction is allowed for payments to foreign government employees or officials if such payments would be illegal under any of the Federal laws of the United States, if the laws of the United States were applicable to the transaction. Since Federal law makes illegal virtually any payment to government officials or employees in return for favorable business dealings, this provision covers most conceivable situations where foreign bribes, kickbacks or similar payments are made. Present law thus attempts to prevent any reduction in tax arising from the payment of foreign bribes.

Under the bill, the provision disallowing a deduction for payments to foreign officials that would be illegal under Federal law if Federal law applied to the transaction would be amended to disallow a deduction only where the payment was in violation of the Foreign Corrupt Practices Act. This change would limit the applicability of section 162 (c) (1) since more transactions are made illegal by the Federal laws of the United States than are made illegal under the Foreign Corrupt Practices Act.

4. S. 1764—Senator Moynihan

Definitions Concerning Cooperative Housing Corporations

Under present law (sec. 216), a tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid to the corporation which represent his or her proportionate share of allowable real estate taxes and interest relating to the corporation's land and buildings. (In addition, to the extent a tenant-stockholder uses depreciable property leased from the cooperative housing corporation in a trade or business or for the production of income, the tenant-stockholder is allowed to take depreciation deductions with respect to the stock the ownership of which gives the tenant-stockholder the right to lease such property.)

In general, for a corporation to qualify as a cooperative housing corporation (which can pass through real estate tax and interest deductions to tenant-stockholders) 80 percent or more of the gross income of the cooperative housing corporation must be derived from tenant-stockholders. The bill would reduce the 80-percent requirement to 50 percent. The bill also would remove the three-year limitation on the period during which an original seller who acquires stock of a cooperative housing corporation from the corporation or by foreclosure is treated as a tenant-stockholder.

II. DESCRIPTION OF BILLS

1. S. 1081—Senators Mathias, Long, Durenberger, Heinz, D'Amato, and Bentsen

Deduction for Self-insurance Set-asides for Liabilities of Design Professionals

Present law

Under present law, deductions by an accrual-basis taxpayer are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy (Treas. Reg. § 1.446-1(c)(1)(ii)). Accordingly, the income tax law generally does not permit a taxpayer to deduct currently amounts set aside in a self-insurance fund or trust to satisfy contingent liabilities, such as future claims based on negligent furnishing of architectural, engineering, or similar services.

Instead, deductions are allowed when liability for a particular act or omission and the amount of the liability have become fixed by litigation or settlement of a claim. Such losses that have been incurred in a trade or business, to the extent not used in the year first deductible, may be carried back for 3 years and carried forward for 15 years. The amount of premiums paid during the year for insurance against future claims generally is currently deductible as a business expense.

Also, under present law, a trust established to provide funds to satisfy contingent liabilities generally does not qualify for tax-exempt status.[1] For example, the tax law does not provide an exemption for income earned on assets set aside by an architect or engineer to satisfy liabilities from professional malpractice. Instead, the Internal Revenue Service takes the position that the income of such a trust is taxed directly to the grantor of the trust under the "grantor trust" rules of the Code.

In the case of product liability losses, the amount of a net operating loss attributable to the product liability can be carried back ten years

[1] However, Code section 501(c)(21) provides an income tax exemption for a qualified, irrevocable trust used by a coal mine operator to self-insure for liabilities, imposed on the operator by statute, to pay benefits to miners disabled with black lung disease. This provision requires as a condition of exemption that there be no right or possibility that either corpus or income of the trust can revert to the coal mine operator which established and funded the trust. Also, a black lung liability self-insurance trust is subject to strict self-dealing prohibitions, prohibitions on improper expenditures, and investment limitations. Contributions by the coal mine operator to fund an exempt section 501(c)(21) trust are deductible, within certain limitations (Code sec. 192).

(Code sec. 172(b)(1)(H)). This special rule does not apply to liabilities based on services performed by the taxpayer or to liabilities arising under warranty.

Issues

The principal issues are whether, as an exception to the general tax rule disallowing deductions for anticipated liabilities, there should be a deduction for amounts set aside to self-insure losses resulting from the furnishing of services by design professionals, such as architects and engineers; and if so, whether the earnings on amounts set aside to fund such liabilities should be exempt from income tax.

Other issues for consideration in connection with the bill include: (1) whether any deduction allowed for anticipated malpractice or warranty claims against design professionals should also be provided to other professionals subject to similar liabilities, such as contractors, lawyers, doctors, nurses, and accountants; (2) whether, as a condition for exemption of income earned on set-aside funds, there should be a requirement that the corpus or income of such funds could not revert to the taxpayer (other than for payment of the taxpayer's service liabilities); and (3) what limitations on investments should apply to assets of exempt set-aside trusts, and what prohibitions should be imposed on improper expenditures and "self-dealing".

Explanation of the bill

In general

Under the bill, an eligible taxpayer could elect to deduct the amount of cash transferred during the year to a trust established by the taxpayer for the purpose of funding the taxpayer's service liability. The deduction would be available to persons engaged in the trade or business of furnishing services in the professional design, surveying, planning, evaluation, preparation of studies or specifications, or inspection of construction as representative of the owner, for the constructtion or modification of a building or other structure.

The funds would have to be transferred to a trust established exclusively to satisfy service liability losses of the taxpayer. The term "service liability" would refer to the taxpayer's liability for personal or property damage attributable to negligence or defects in, or breach of warranty regarding, the design, etc., for the construction or modification of buildings or other structures.

The bill would impose various restrictions on a service liability trust eligible to receive deductible amounts. For example, the assets of the trust or insurer could not be borrowed, used as security for a loan, or otherwise used by the taxpayer except for payment of service liability losses,[2] and limits would be imposed on investment of such assets. The trustee of the service liability trust generally would have to be a bank, and trust funds could not be commingled with other assets.

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[2] The term "service liability loss" would mean any loss attributable to the taxpayer's service liability, including payment on claims against the taxpayer for service liability; expenses incurred in the investigation, settlement, and defense of any such claims; and administrative and other incidental expenses of a service liability trust in connection with the operation of the trust and the processing of claims against the taxpayer.

Limitation on deduction

The amount of the deduction for the year would be subject to a limitation. The amount of limitation would depend on whether the taxpayer has a "severe service liability insurance problem."[3]

Severe problem.—If the taxpayer has a severe liability insurance problem for the taxable year, the deduction would be limited to the lesser of: (1) five percent of gross receipts derived from the trade or business of furnishing qualified services; (2) 15 percent of average yearly gross receipts from the furnishing of qualified services during the base period,[4] reduced by the balance of the taxpayer's service liability trust; or (3) $100,000.

No severe problem.—In the case of a taxpayer who elects this provision and who does not have a severe service liability insurance problem, the deduction could not exceed the lesser of (1) two percent of gross receipts derived from the trade or business of furnishing qualified services; (2) ten percent of average yearly gross receipts from the furnishing of qualified services during the base period,[4] reduced by the balance of the taxpayer's service liability trust; or (3) $25,000.

Distributions

Authorized distributions from a service liability trust would be included in the gross income of the taxpayer for the taxable year in which such authorized distributions are made. However, the distribution shall not be treated as "compensation by insurance or otherwise" for purposes of determining the amount of the loss deductible under section 165(a).

In the case of an unauthorized distribution, the tax liability of the taxpayer would be increased by an amount equal to ten percent of the excess of the distribution over the allowable deduction for the taxable year for service liability losses. Generally, the ten-percent penalty would not apply if (1) a corrective withdrawal of an excess contribution is made prior to the last day (including extensions) for filing the taxpayer's return; (2) the taxpayer establishes to the satisfaction of the Internal Revenue Service that there was reasonable cause to create a service liability trust but that a change in circumstances has occurred which obviated the need for continuing the trust; (3) the distributed amount is, within 90 days of distribution, transferred to another service liability trust; (4) the distribution is made because of the liquidation of the taxpayer's trade or business, which may result in service liability: or (5) under Treasury regulations, the amount in the service liability trust is deemed to be distributed.[5]

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[3] A taxpayer would have a "severe service liability insurance problem" if the taxpayer is unable to obtain a premium quotation for service liability insurance, with coverage of up to $1 million, with a reasonable deductible amount (the deductible amount not exceeding the premium, in any case), from any insurer, or the lowest insurance premium quotation for service liability insurance coverage of up to $1 million, with a reasonable deductible amount (but not in excess of the premium), obtained by the taxpayer was equal to more than two percent of the gross receipts of the taxpayer for the taxable year.

[4] The base period would be the shorter of the period beginning with the earliest preceding taxable year for which the taxpayer elected this provision and ending with the current taxable year or a five-year period which includes the taxpayer's current and four preceding taxable years.

[5] In general, the funds in the service liability trust would be deemed to be distributed only if there is a transfer of more than 50 percent of the control of the taxpayer's trade or business.

Accumulations deemed reasonable

The bill also provides that, in the case of a corporation, amounts accumulated in the taxpayer's service liability trust would be deemed accumulated for the reasonable needs of the trade or business and thus not subject to the accumulated earnings tax (Code secs. 531–537).

Exempt status

Under the bill, the service liability trust of the taxpayer would be exempt from Federal income tax.

Effective date

The provisions of the bill would be effective with respect to taxable years beginning after the date of enactment.

Revenue effect

This bill is estimated to reduce fiscal year budget receipts by $22 million in 1982, $58 million in 1983, $67 million in 1984, $72 million in 1985, and $76 million in 1986. The estimate assumes the bill is effective for taxable years beginning after December 31, 1981.

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2. S. 1594—Senator Symms

Increase in Civil Fraud Penalty and Limitation of Penalty to Portion of Underpayment that is Attributable to Fraud

Present law

Under present law, a taxpayer who underpays any income, gift, or windfall profit tax because of negligence, or any tax because of fraud, is subject to certain penalties (Code sec. 6653). The penalty for negligence is 5 percent of any underpayment if any part of the underpayment is due to negligence or intentional disregard of rules and regulations but not with intent to defraud. In addition, effective for the payment of taxes due after December 31, 1981, there is an addition to tax equal to one-half the interest payable with respect to the portion of an underpayment that is attributable to negligent or intentional disregard of rules and regulations.[1]

The fraud penalty is 50 percent of any underpayment of tax if any part of the underpayment is due to fraud. The negligence penalty does not apply if the fraud penalty is imposed. In the case of a joint return, this penalty does not apply with respect to the payment of tax by a spouse unless some part of the underpayment is due to the fraud of such spouse.

For purposes of these penalties, an underpayment generally is defined as a deficiency. Thus, it is the amount by which the tax imposed exceeds the amount of tax shown on a timely filed return.

Issue

The issue is whether the amount of the civil fraud penalty should be increased, on the one hand, but limited, on the other hand, to the portion of the underpayment that is due to fraud.

Explanation of the bill

The bill would increase the amount of the civil fraud penalty but would limit the penalty to the portion of an underpayment that is due to fraud.

Under the bill, if any portion of an underpayment of tax is due to fraud, then there would be an addition to tax of an amount equal to 100 percent of that portion of the underpayment. In a judicial proceeding, the United States would have the burden of establishing that a portion of a taxpayer's underpayment is due to fraud. If the U.S. carried this burden, then the burden of proof would shift to the taxpayer with respect to the issue of whether any other portion of such underpayment is not due to fraud.

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[1] This new penalty was added by section 722(b) of the Economic Recovery Tax Act of 1981 (P.L. 97–34).

Other provisions of the civil fraud penalty would remain unchanged. Thus, the penalty would continue to be in lieu of the negligence penalty. Furthermore, in the case of a joint return, the civil fraud penalty would not apply with respect to the tax of a spouse unless some portion of the underpayment was due to the fraud of such spouse.

Effective date

The provisions of the bill would apply to additions to tax made after the date of enactment.

Revenue effect

The revenue estimate for this bill is not available.

3. S. 1749—Senator Chafee

Deductibility of Payments Under the Foreign Corrupt Practices Act

Present law

Under present law (sec. 162(c)(1)), no deduction is allowed for payments to foreign government employees or officials if such payments would be illegal under any of the Federal laws of the United States, if the laws of the United States were applicable to the transaction. Since Federal law makes illegal virtually any payment to government officials or employees in return for favorable business dealings, this provision covers most conceivable situations where foreign bribes, kickbacks or similar payments are made. Present law thus attempts to prevent any reduction in tax arising from the payment of foreign bribes.

In a further attempt to curtail foreign bribes by U.S. businessmen Congress enacted the Foreign Corrupt Practices Act of 1977 ("FCPA"). In general, this Act makes it illegal for U.S. persons or their agents to make, offer, or authorize either directly or indirectly, payments to foreign government officials, foreign political parties, or foreign political candidates with the intent of influencing official action in order to obtain business. Violations under FCPA can result in fines of up to $1 million for corporations and $10,000 for individuals, and imprisonment for up to five years.

Issue

The issue is whether the tax law should be changed to allow taxpayers a deduction for payments to foreign officials if those payments do not violate the Foreign Corrupt Practices Act.

Explanation of the bill

Under the bill, the provision disallowing a deduction for payments to foreign officials that would be illegal under Federal law if Federal law applied to the transaction would be amended to disallow a deduction only where the payment was in violation of the Foreign Corrupt Practices Act. This change would limit the applicability of Code section 162(c)(1) since more transactions are made illegal by the Federal laws of the United States than are made illegal under the Foreign Corrupt Practices Act.

There are two principal types of payments that would be allowed as a deduction under the bill that are not deductible under present law. The first are facilitating or "grease" payments. These are payments made to government officials to facilitate routine administrative actions that are nondiscretionary on their part. Thus, payments to a customs official to expedite goods through customs would be allowed as a deductible payment under the bill.

The second type of payment that would be deductible under the bill is one that is a legal payment under the local law of the foreign jurisdiction but which violates a Federal law other than the Foreign Corrupt Practices Act.

Effective date

The provisions of the bill would be effective for payments made after the date of enactment.

Revenue effect

The revenue estimate for this bill is not available.

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4. S. 1764—Senator Moynihan

Definitions Concerning Cooperative Housing Corporations

Present law

Under present law (sec. 216), a tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid to the corporation which represent his or her proportionate share of allowable real estate taxes and interest relating to the corporation's land and buildings. (In addition, to the extent a tenant-stockholder uses depreciable property leased from the cooperative housing corporation in a trade or business or for the production of income, the tenant-stockholder is allowed to take depreciation deductions with respect to the stock the ownership of which gives the tenant-stockholder the right to lease such property.)

In general, for a corporation to qualify as a cooperative housing corporation (which can pass through real estate tax and interest deductions to tenant-stockholders), 80 percent or more of the gross income of the cooperative housing corporation must be derived from individual tenant-stockholders.

Under the Revenue Act of 1978 (P.L. 95–600), as amended by the Technical Corrections Act of 1979 (P.L. 96–222), if an original seller (i.e. a person who conveys apartments or houses (or leaseholds therein) to a cooperative housing corporation) acquires stock of a cooperative housing corporation either from the corporation or by foreclosure, the original seller shall be treated as a tenant-stockholder for a period not to exceed three years from the date of the acquisition of the stock. However, except in the case of an acquisition of stock of a cooperative housing corporation by foreclosure, this rule only applies to stock acquired from the cooperative housing corporation which occurs not later than one year after the date on which the apartments or houses (or leaseholds therein) are transferred by the original seller to the corporation.

Issues

The issues are (1) whether the requirement that 80 percent or more of the gross income of a cooperative housing corporation must be derived from tenant-stockholders should be reduced, and (2) whether the three-year limitation on the period during which an original seller who acquires stock of a cooperative housing corporation from the corporation or by foreclosure is treated as a tenant-stockholder should be removed.

Explanation of the bill

The bill would provide that in order for a corporation to qualify as a cooperative housing corporation at least 50 percent of its gross income must be derived from tenant-stockholders, thereby reducing the 80-percent requirement under present law.

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The bill also would provide that if an original seller acquires any stock of the cooperative housing corporation from the corporation within one year after the transfer of the dwelling units, or by foreclosure, the original seller shall be treated as a tenant-stockholder. The three-year limitation on such treatment under present law would be removed.

Effective date

The provisions of the bill would apply to taxable years beginning after the date of enactment.

Revenue effect

It is estimated that this bill would reduce budget receipts by less than $5 million annually.

II

97TH CONGRESS
1ST SESSION

S. 1081

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

IN THE SENATE OF THE UNITED STATES

APRIL 30 (legislative day, APRIL 27), 1981

Mr. MATHIAS (for himself, Mr. LONG, and Mr. DURENBERGER) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

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

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE

This Act may be cited as the "Design Liability Supplemental Protection Act of 1981".

SEC. 2. SELF-INSURANCE FOR SERVICE LIABILITY LOSSES.

(a) Loss Deduction Allowed for Contributions to Trust.—Section 165 of the Internal Revenue Code of 1954 (relating to losses) is amended by redesignating subsection (i) as subsection (j) and by inserting immediately after subsection (h) the following new subsection:

"(i) Self-Insurance for Service Losses and Expenses.—

"(1) General rule.—In the case of an eligible taxpayer who elects the benefits of this subsection for the taxable year (in accordance with regulations prescribed by the Secretary), there shall be allowed as a deduction under subsection (a) the sum of any amounts (other than rollover amounts described in paragraph (5)(C)) transferred by the taxpayer for such taxable year to the taxpayer's service liability trust.

"(2) Eligible taxpayer.—For purposes of this subsection, the term 'eligible taxpayer' means any person who is engaged in a trade or business which involves the furnishing of services (within the meaning of paragraph (10)(A)).

"(3) Limitation.—The amount of the deduction allowable because of paragraph (1) shall not exceed the amounts specified in subparagraph (A) or (B) of this paragraph, whichever is applicable.

"(A) TAXPAYER WITH SEVERE SERVICE LIABILITY INSURANCE PROBLEM.—In the case of a taxpayer who has a severe service liability insurance problem (as defined in paragraph (10)(E)) for the taxable year, the amount for such taxpayer determined under paragraph (1) shall not exceed the least of—

"(i) 5 percent of the gross receipts of the taxpayer for such taxable year from the furnishing of services with respect to which the taxpayer may incur any service liability,

"(ii) the amount which, when added to the balance of the taxpayer's service liability trust, equals 15 percent of the taxpayer's average yearly gross receipts from the furnishing of services during the base period, or

"(iii) $100,000.

"(B) OTHER TAXPAYERS.—In the case of a taxpayer who does not have a severe service liability insurance problem for the taxable year, the amount determined under paragraph (1) shall not exceed the least of—

"(i) 2 percent of the gross receipts of the taxpayer for such taxable year from the furnishing of services with respect to which the taxpayer may incur any service liability,

"(ii) the amount which, when added to the balance of the taxpayer's service liability trust, equals 10 percent of the taxpayer's average yearly gross receipts from the furnishing of services during the base period, or

"(iii) $25,000.

"(C) BASE PERIOD.—For the purpose of this paragraph, the term 'base period' means the shorter of—

"(i) the period beginning with the earliest preceding taxable year for which the taxpayer elected to have this subsection apply and ending with the current taxable year, or

"(ii) the 5-year period which includes the current taxable year and the 4 taxable years immediately preceding the current taxable year.

"(4) TREATMENT OF DISTRIBUTIONS FROM A SERVICE LIABILITY TRUST.—

"(A) IN GENERAL.—If any amount in a service liability trust is distributed during a taxable year—

"(i) the amount of the distribution (other than amounts described in paragraph (5)(A) and rollover amounts described in paragraph (5)(C)) shall be included in the gross income of the taxpayer from whose trust the distribution is made, and

"(ii) the distribution shall not be treated, for the purpose of determining the amount of the deduction allowable for the taxable year under subsection (a) (determined without reference to this subsection), as compensation by insurance or otherwise.

"(B) PENALTY FOR UNAUTHORIZED DISTRIBUTION.—Except as provided in paragraph (5), the liability of the taxpayer for the tax imposed by this chapter for the taxable year shall be increased by an amount equal to 10 percent of the excess (if any) of—

"(i) the amount distributed to the taxpayer for the taxable year from a service liability trust, over

"(ii) the amount of the deductions allowable for the taxable year which are attributable to service liability losses (within the meaning of paragraph (10)(C)).

"(5) Exceptions.—

"(A) Corrective withdrawal of excess contributions.—Subparagraph (B) of paragraph (4) shall not apply to amounts distributed from any service liability trust no later than the last day prescribed by law for filing the taxpayer's return with respect to the tax imposed by this chapter for the taxable year (including extensions thereof) to the extent that the amount of such distribution is not more than the excess of—

"(i) the aggregate amount of payments by the taxpayer to such trust for the taxable year, over

"(ii) the maximum amount of such payments which may be deducted under paragraph (3).

"(B) Change in circumstances.—Subparagraph (B) of paragraph (4) shall not apply to a distribution from a service liability trust if the taxpayer establishes, in accordance with regulations prescribed by the Secretary, that—

"(i) there was reasonable cause for the creation of the service liability trust, and

"(ii) there has been a change in circumstances concerning the taxpayer so that the continued maintenance of such a trust no longer serves a trade or business purpose.

No exception shall be granted under this subparagraph while any amounts are accumulated by the taxpayer pursuant to the second sentence of section 537(b)(5).

"(C) ROLLOVER AMOUNTS.—Subparagraph (B) of paragraph (4) shall not apply to a distribution from a service liability trust to the extent that all or any portion of the distribution is transferred by the taxpayer to another service liability trust of the taxpayer not later than the 90th day after the day on which the taxpayer receives such distribution. This subparagraph shall not apply to any amount distributed from a service liability trust if at any time during the 1-year period ending on the day of such distribution any other distribution to the taxpayer was not subject to paragraph (4)(B) on account of this subparagraph.

"(D) COMPLETE LIQUIDATION.—Subparagraph (B) of paragraph (4) shall ~~not apply~~ to a distribution from a service liability trust made on account of the liquidation of the trade or business of the taxpayer which may result in service liability. The Secretary may prescribe regulations providing the extent to which this subparagraph shall not apply to amounts distributed to a taxpayer who remains subject to outstanding service liability claims.

"(E) DEEMED DISTRIBUTIONS.—Subparagraph (B) of paragraph (4) shall not apply to amounts treated as a distribution under paragraph (6).

"(6) SALE MAY BE TREATED AS A DISTRIBUTION.—The Secretary may prescribe regulations specifying facts and circumstances under which the service liability trust of an eligible taxpayer shall be deemed to be distributed. Such regulations shall apply only where there is a transfer (in one transaction, or in a series of related transactions) of more than 50 percent of the control of the trade or business which is the beneficiary of the service liability trust. For purposes of this paragraph, 'control' means—

"(A) voting stock, in the case of a corporation, or

"(B) capital or profits interest in the case of a partnership or sole proprietorship.

"(7) TIME WHEN PAYMENTS DEEMED MADE.—For purposes of this subsection, a taxpayer shall be deemed to have made a payment to this service liability trust on the last day of the preceding taxable year if the payment is made on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof).

"(8) PAYMENTS TO TRUST TO BE IN CASH.—No deduction shall be allowed under paragraph (1) with respect to any payment to a taxpayer's service liability trust other than a payment in cash.

"(9) SPECIAL RULE FOR CONTROLLED GROUPS.—

"(A) IN GENERAL.—For purposes of paragraph (3)—

"(i) in the case of the taxpayer who, during a taxable year, is a member of a controlled group of corporations, only gross receipts properly attributable under section 482 to such taxpayer for such year shall be taken into account; and

"(ii) the aggregate deductions under this subsection taken by all of the members of a controlled group of corporations for each taxable year shall be limited to the amount that would be permitted under paragraph (3) if all the component members of such group were considered to be a single taxpayer.

"(B) DEFINITION OF CONTROLLED GROUP.—For the purpose of subparagraph (A), the term 'controlled group of corporations' has the meaning given such term by paragraphs (1), (2), and (3) of subsection (a) of section 1563.

"(C) DETERMINATION OF CONTROLLED STATUS.—The determination of whether a taxpayer is a member of a controlled group of corporations for a taxable year shall be made on the December 31 which is included in such year.

"(D) CONTROLLED GROUPS CONTAINING PERSONS OTHER THAN CORPORATIONS.—Under regulations prescribed by the Secretary, principles similar to the principles of subparagraphs (A), (B), and (C) shall be applied to groups of taxpayers under common control where one or more of such taxpayers is not a corporation.

"(10) DEFINITIONS.—For purposes of this subsection—

"(A) SERVICE.—The term 'service' means any service which—

"(i) is furnished in the professional design, surveying, planning, evaluation, preparation of studies or specifications, or inspection of construction as a representative of the owner, for the construction or modification of any building or structure on real property; and

"(ii) is performed by a person who is licensed under State law as an architect or engineer.

"(B) SERVICE LIABILITY.—The term 'service liability' means liability for damages arising out of physical injury or emotional harm to individuals or damage to or loss of the use of property attributable to negligence in, breach of warranty regarding, or defects in the professional design, planning, evaluation, preparation of specifications, or inspection of construction as a representative of the owner, by the taxpayer (whether in whole or in part) for the construction or modification of buildings or structures on real property.

"(C) SERVICE LIABILITY LOSS.—The term 'service liability loss' means any loss attributable to the service liability of the taxpayer, including—

"(i) payment on any claim against the taxpayer for service liability, "(ii) expenses incurred in the investigation, settlement, and defense of any claims against the taxpayer for service liability, and

"(iii) administrative and other incidental expenses of a service liability trust in connection with the operation of the trust and the processing of claims against the taxpayer.

"(D) SERVICE LIABILITY TRUST.—The term 'service liability trust' means any trust—

"(i) established in writing which is created or organized under the laws of the United States or of any State (including the District of Columbia) by the taxpayer;

"(ii) the trustee of which is a bank (as defined in section 581) or another person (other than the taxpayer or any component member of a controlled group of corporations, within the meaning of paragraph (9), of which the taxpayer is a member) who demonstrates to the satisfaction of the Secretary that the manner in which that other person will administer the trust will be consistent with the purposes for which the trust is established;

"(iii) the exclusive purpose of which is to satisfy, in whole or part, the service liability losses sustained by the taxpayer;

"(iv) which, by its terms, is required, in any year in which the taxpayer sustains a service liability loss (within the meaning of subparagraph (C)), to make distributions which (considered together with distributions from any other service liability trust of the taxpayer) equal the lesser of (1) the service liability loss of the taxpayer for the year, or (2) the total amount of the value of all service liability trusts of the taxpayer;

"(v) the assets of which will not be commingled with any other property other than in a common trust fund (as defined in section 584) and will only be invested as permitted in paragraph (11); and

"(vi) the assets of which may not be borrowed, used as security for a loan, or otherwise used by the taxpayer for any purpose other than that described in clause (iii).

"(E) SEVERE SERVICE LIABILITY INSURANCE PROBLEM.—A taxpayer has a severe service liability insurance problem for a taxable year if, for such taxable year—

"(i) the taxpayer is unable to obtain a premium quotation for service liability insurance, with coverage of up to $1,000,000, with a reasonable deductible amount (but in no case with a deductible amount greater than the premium), from any insurer, or

"(ii) the lowest insurance premium quotation for service liability insurance, with coverage of up to $1,000,000, with a reasonable deductible amount (but in no case with a deductible amount greater than the premium), obtained by the taxpayer was equal to more than 2 percent of the gross receipts of the taxpayer for such taxable year.

"(11) RESTRICTIONS ON INVESTMENTS OF ASSETS.—The assets of a service liability trust may not be invested in anything other than—

"(A) public debt securities of the United States,

"(B) obligations of a State or local government which are not in default as to principal or interest, "(C) time or demand deposits in a bank (as defined in section 581) insured by the Federal Deposit Insurance Corporation, a savings and loan association insured by the Federal Savings and Loan Insurance Corporation, or an insured credit union (as defined in section 101(6) of the Federal Credit Union Act) located in the United States, or,

"(D) any other asset which, under the laws of the State where the service liability trust is organized, is a permissible subject for investment by trustees or fiduciaries administering a trust within such jurisdiction, other than the stock or securities of, or a capital interest in, any eligible taxpayer contributing to that trust.

"(12) EXEMPTION FROM LEVY, ETC.—

"(A) GENERAL RULE.—Any amount in the service liability trust of the taxpayer shall be exempt from levy.

"(B) EXCEPTIONS.—Subparagraph (A) shall not apply to any levy—

"(i) by reason of any service liability of the taxpayer, or

"(ii) by the United States, any State, or the District of Columbia.".

(b) TAX-EXEMPT STATUS FOR SERVICE LIABILITY TRUST.—Subsection (c) of section 501 of the Internal Revenue Code of 1954 (relating to organizations exempt from tax) is amended by adding at the end thereof the following new paragraph:

"(22) A service liability trust (within the meaning of section 165(i)(10)(D)).".

(c) ACCUMULATED EARNINGS TAX.—Subsection (b) of section 537 of such Code (relating to accumulated earnings tax) is amended by redesignating paragraph (5) as paragraph (6) and by inserting after paragraph (4) the following new paragraph:

"(5) SERVICE LIABILITY LOSS RESERVES.—Amounts accumulated in a taxpayer's service liability trust shall be treated as amounts accumulated for the reasonably anticipated needs of the business of the taxpayer to the extent those amounts are deductible under the rules of section 165(i). The accumulation of reasonable amounts, in addition to amounts deductible under section 165(i), for the payment of reasonably anticipated service liability losses (as defined in section 165(i)(10)(C)), as determined under regulations prescribed by the Secretary, shall be treated as accumulated for the reasonably anticipated needs of the business.".

SEC. 3. EFFECTIVE DATE.

The amendments made by section 2 of this Act shall apply with respect to taxable years beginning after the date of enactment of this Act.

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II

97TH CONGRESS
1ST SESSION

S. 1594

To amend the Internal Revenue Code of 1954 to apply the civil fraud penalty only to that portion of an underpayment which is attributable to fraud.

IN THE SENATE OF THE UNITED STATES

AUGUST 3 (legislative day, JULY 8), 1981

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

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A BILL

To amend the Internal Revenue Code of 1954 to apply the civil fraud penalty only to that portion of an underpayment which is attributable to fraud.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subsection (b) of section 6653 of the Internal Revenue Code of 1954 (relating to fraud) is amended to read as follows:

"(b) FRAUD.—

"(1) IN GENERAL.—If any portion of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 100 percent of such portion of the underpayment. In the case of income taxes and gift taxes, this amount shall be in lieu of any amount determined under subsection (a). In the case of a joint return under section 6013, this subsection shall not apply with respect to the tax of a spouse unless some portion of the underpayment is due to the fraud of such spouse.

"(2) BURDEN OF PROOF.—If the United States establishes in a proceeding brought in a district court, the Tax Court, or the Court of Claims that a portion of the underpayment is due to fraud, then the taxpayer shall have the burden of proof with respect to the issue of whether any other portion of such underpayment is not due to such fraud.".

(b) EFFECTIVE DATE.—The amendment made by this Act shall apply with respect to additions to tax made after the date of enactment of this Act.

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II

97TH CONGRESS
1ST SESSION

S. 1749

To amend the Internal Revenue Code of 1954 with respect to the deductibility of certain payments to officials and employees of foreign governments.

IN THE SENATE OF THE UNITED STATES

OCTOBER 19 (legislative day, OCTOBER 14), 1981

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

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A BILL

To amend the Internal Revenue Code of 1954 with respect to the deductibility of certain payments to officials and employees of foreign governments.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That paragraph (1) of section 162(c) of the Internal Revenue Code of 1954 (relating to illegal payments to Government officials or employees) is amended—

(1) by striking out "the laws of the United States if such laws were applicable to such payment and to

such official or employee" and inserting in lieu thereof "the Foreign Corrupt Practices Act of 1977", and

(2) by striking out "(or would be unlawful under the laws of the United States)" and inserting in lieu thereof "(or would be unlawful under the Foreign Corrupt Practices Act of 1977)".

SEC. 2. The amendments made by this Act shall apply to payments made after the date of the enactment of this Act.

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II

97TH CONGRESS
1ST SESSION

S. 1764

To amend the provisions of the Internal Revenue Code related to cooperative housing corporations.

IN THE SENATE OF THE UNITED STATES

OCTOBER 22 (legislative day, OCTOBER 14), 1981

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

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A BILL

To amend the provisions of the Internal Revenue Code related to cooperative housing corporations.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subparagraph (D) of section 216(b)(1) of the Internal Revenue Code (defining cooperative housing corporation) is amended by deleting "80 percent" and inserting in lieu thereof "50 percent".

(b) Subparagraph (A) of section 216(b)(6) of such Code (relating to the definition of tenant-stockholder) is amended by placing a period after the term "tenant-stockholder" and by deleting the phrase "for a period not to exceed 3 years from the date of the acquisition of such stock.".

(c) These amendments shall apply in tax years beginning after the date of enactment.

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Senator PACKWOOD. The committee will come to order.

It is my intention to take Secretary Chapoton first, unless Senator Mathias comes right now, in which case the Secretary said he would step aside momentarily while the Senator testified. And then we will go right through the witnesses as they are listed.

I might, again, encourage the witnesses to place their statements in the record in full and abbreviate their testimony, because we will be holding to the time limits this committee follows. You don't have to ask to have your statements put in the record. They will, as a matter of course, be placed in the record in their entirety.

Senator Byrd.

Why don't we start, then, with Secretary Chapoton, if he wants to comment on the bills that we have before us today.

Mr. Secretary.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Secretary CHAPOTON. Thank you, Mr. Chairman.

I will be rather brief, I hope. There are four bills. The first one, taken in order, would be 1081. That bill would amend Code section 165 and 501, to provide both current deduction for contributions to certain professional liability self-insurance accounts and tax exemption for interest earnings on such trust accounts. It would apply only to malpractice insurance funds for architects, engineers, and design professionals. And then it has two different limits on the deductible amount: A $100,000 deductible limit if the architect or engineer is faced with an insurance premium quotation exceeding 2 percent of annual gross receipts, and a $25,000 limit for all other taxpayers.

There are provisions dealing with unauthorized distributions from these accounts. If an unauthorized distribution is made, there is a 10-percent penalty tax similar to the penalty tax we have on unauthorized withdrawals from individual retirement accounts and H.R. 10 plans. The 10-percent penalty tax would not apply if the withdrawal is made to correct excess contributions, or on the dissolution of the account, or if the amount is simply no longer needed, or in certain other cases, as well.

Mr. Chairman, we oppose S. 1081 for a number of reasons. The one argument made in favor of this type of benefit for a self-insurance arrangement is that the current law discriminates in favor of commercial insurance and against self-insuring, because commercial insurance premiums are currently deductible and gross amounts set aside for self-insurance are not. If we analyze that in depth—I won't go into that here, because there is more to it than would appear on the face of it—we do not think that is a proper conclusion. We think the tax law is neutral and that, indeed, giving a deduction for current amounts set aside for self insurance plus an exclusion of the income earned on such amounts would give a tremendous incentive or bias, if you will, in favor of self-insured plans. I think it can be seen rather readily if you have a deduction for an amount that you still control and can still utilize for investment purposes, then that is a significant benefit that does not exist when you have to pay a premium to a third party and the funds have left your coffers before you get the deduction.

For that reason and for the reason that self insurance is not as efficient as the sharing of risk which is involved by commercial insurance entities, there is rather a significant revenue. loss estimated for this proposal, running up to $67 million in 1984.

I would also just mention that from a more technical standpoint, the ability to earn income on these self-insurance type accounts on a tax-free basis would be quite a significant benefit. Because of the mechanics of the way the statute is drafted, it would be possible to withdraw the principal amount subject to or in a circumstance that would not give rise to the penalty tax—that is the 10-percent penalty tax—and leave the earnings in the account. The earnings could later be utilized to pay insurance or losses and thus would never be subjected to tax.

So for that technical reason and for policy reasons I have stated, we do oppose that bill.

S. 1594 would increase the civil fraud penalty. The present civil fraud penalty is 50 percent where the taxpayer fraudulently attempts to underpay his taxes—50 percent of all additional taxes owed. S. 1594 would increase the penalty from 50 percent to 100 percent, but would limit the penalty to the portion of the underpayment attributable to the taxpayer's fraud. It would also shift the burden of proof. Once the Government proves that a portion of an underpayment is due to fraud—the taxpayer would have the burden of proving that other portions of the deficiency on his return were not due to fraud.

This proposal has a lot on its face to recommend it. It makes the penalty fit the crime. Under current law, since the penalty is imposed on the entire deficiency for the year, there are rather capricious results in some circumstances.

But if we could, Mr. Chairman, we would like not to take a position on this bill, at this time and to study it further. There is a good deal of concern within Treasury, IRS, and the Justice Department that the bill would significantly reduce the civil fraud penalty and would thereby have ramifications throughout the enforcement process. We want to make sure that we consider all of these ramifications before we consider supporting this proposal. We do recognize the merits of the arguments behind it, but we want to see whether the present inadequacies of the present civil fraud penalty are sufficient to overcome the risk of eroding its deterrent effect. We will report back to the committee after we complete our study.

Senator PACKWOOD. Let me interrupt you just a moment.

Mac, do you mind if Secretary Chapoton finishes his comments on the other two bills? I think they are rather short. Then we will put you on right away. Do you have to preside at 9:30?

Senator MATHIAS. Yes.

Secretary PACKWOOD. Mr. Secretary, then, if you don't mind, we will put Senator Mathias on.

Senator MATHIAS. I may not even interrupt you, but ask permission that my statement be included in the record.

Senator PACKWOOD. It will be included in the record, and we will put it at the start of the hearing and not interrupt the Secretary's statement.

[The prepared statement follows:]

PREPARED STATEMENT OF SENATOR CHARLES McC. MATHIAS, JR.

Mr. Chairman, I appear before your subcommittee today to talk about my service liability supplemental protection bill, S. 1081, which I introduced on April 30 with Senators Long and Durenberger. Since then, Senators Heinz, D'Amato, and Bentsen have joined as cosponosrs. I would like to sketch briefly the reasons for my involvement in the troubled area of professional liability.

Over the past 20 years, liability law has changed substantially, particularly with the adoption of strict tort liability standards. Earlier standards had required an injured user of a product to show that negligence on the part of the manufacturer or designer was directly connected with the injury suffered. Under current liability law, the showing of negligence can be dispensed with: the injured user need only show that his injuries were caused by a defective condition in the product that made it unreasonably dangerous.

These developments, coupled with the increasing cost and complexity of the buildings that architects and engineers are designing, have dramatically increased the number and severity of the liability claims these design professionals are exposed to, as woll as the cost of the insurance they must buy to protect themselves. The number of claims against architects and engineers has quadrupled in the past 20 years, while the size of the claims has doubled in the last 10.

As a result, insurance costs for design professionals have skyrocketed. A Silver Spring architect wrote me that:

This office has never had a liability claim in 30 years of practice, yet our premium has increased 600 percent in the last 12 years.

Surveys show that the average cost of professional liability insurance rose more than 26 percent in 1979 alone. That same year, 24 percent of the engineering and architectural design firms went without insurance altogether, at considerable risk. In some regions of the country—in California and Texas for instance—as many as 49 percent of design firms go bare.

Under the leadership of the chairman of this subcommittee, a risk retention bill passed the Senate last summer and became Public Law 97-45 on September 25. This bill is primarily designed to help manufacturers cope with their product liability problems by allowing them to form cooperatives to provide product liability self-insurance.

But, as I have indicated, the problem is not confined to manufacturers. The design profession is being forced to the wall by rising insurance rates. Congress has begun to act this year to bring about significant product liability reform. If the tide of reform continues to rise, we should see that it lifts all boats and that we don't leave the design profession on a short anchor line.

S. 1081 is a small business initiative. I have worked closely with architects and engineers from Maryland and across the country in shaping a bill that will help small design firms survive their liability problems in our increasingly litigious society. Faced with a growing number of lawsuits and great increase in the cost of liability insurance, small design enterprises have reached a near-crisis situation. A recent survey shows that nearly 80 percent of the companies in the field have fewer than 20 employees. Such small-scale business operations provide two-thirds of this country's jobs. And, if we are to get our economy moving, we must begin here. Yet it is these crucial smaller firms that are between a rock and a hard place on liability insurance.

My bill would provide some relief by allowing design professionals to deduct from gross income the money they put into these very limited self-insurance funds. In practice, I do not expect the bill to cut into the business of the insurance companies. These small self-insurance funds will only supplement conventional insurance, as the title implies. Design professionals will use them for low-end coverage, which is often unprotected anyway because of high deductibles, and will rely on ordinary insurance channels to cover their upper exposure. With the high risk end covered, they will pay a lower premium and could even afford more insurance, which is in everyone's interest.

In protecting the hard-pressed professionals, it is imperative that we also take into account the Treasury Deptarment's concern about revenue loss. A privately-commissioned study last year estimated that the Federal income tax savings to architects and engineers for 1981 would be approximately $50 million. This figure is by no means a prohibitive revenue loss for Treasury. I will be interested to hear if the Treasury Department has an updated figure on the revenues loss.

All of us will be hurt if some manufacturers and professionals have to cut back their activities or drop an innovative idea, or even go out of business, because they can't afford insurance protection. The design liability reforms of S. 1081 will not only benefit the self-insurers, but will help to see that the injured consumers are compensated on those rare occasions when accidents happen. We all agree that small business needs help. This is a good place to start.

STATEMENT OF HON. CHARLES McC. MATHIAS, A U.S. SENATOR FROM THE STATE OF MARYLAND

Senator MATHIAS. I would just say to the committee, very briefly, this: that it is a small business initiative, that it looks to the liabilities of architects and engineers who are being hit doubly hard by conditions in the business world today. I believe the figure is that claims and suits against architects, engineers and small businessmen in the same general category have quadrupled in the last 20 years, while the size of the claims has doubled in the last 10. This has created just enormous burdens on the professions of architects and engineers and other design professionals.

What we would do here would not only benefit self insurers, but I think it will help to see that individual consumers are compensated, because it provides a method by which we can in fact compensate people who have just claims.

I think the cost to the Treasury will not be excessive, and I believe that the impact on the insurance industry will not be excessive, because what will happen, I believe, is that self-insurers will take care of that expensive part of their liability coverage which is the low end through this method, and then for the higher and more rare cases of excessive liability, they can go to commercial insurance.

So I would submit my statement for the record. I thank the Secretary for his indulgence, and I thank the Chairman for arranging this hearing.

Senator, thank you very much.

Secretary CHAPOTON. The third bill before the subcommittee, Mr. Chairman, is S. 1749, dealing with the deductibility of payments unther the Foreign Corrupt Practices Act. 1749 is a small part of S. 708, which would modify in a substantial way the Foreign Corrupt Practices Act.

One of the proposed modifications of 708 would limit the application of the act to practices that violate the law of the other country in question. The present tax code provides that income tax deductions are not allowed for any payment made to an official employee of a foreign government if the payment would be unlawful under the laws of the United States, if they apply to the payment and the laws apply to such official or employee.

Just to make it brief, we do support S. 1749. We think it would be a desirable change in the law in a number of respects. It would provide one definition of prohibited payments for both the code and the Foreign Corrupt Practices Act and would simplify and improve current law.

S. 1764 is the final bill before you. It relates to cooperative housing corporations. It would reduce the percentage of gross income that must be derived by a cooperative housing corporation from tenant stockholders from the present level of 80 percent of gross income to 50 percent, and it would also eliminate the 3-year limitation on the period during which an original seller holding stock in a cooperative housing corporation will be treated as a tenant stockholder.

A tenant stockholder in a cooperative housing corporation is treated, for all intents and purposes, as though he owned a portion of the interest in a property owned by the cooperative corporation directly. He is entitled to deduct amounts paid to the corporation representing his proportionate share of real estate taxes and interest, and if he leases his apartment, he is entitled to take depreciation directly as if he owned that portion of the property directly.

If cooperative corporations dealt only with their tenant stockholders, there would be no problem; but they serve a dual role. In addition to dealing with their tenant stockholders, they engage in investment activities and engage in transactions with outsiders. Therefore, rules have to be provided for taxing separately income derived from investments and outsiders.

Currently we do know that co-ops are availed of to reduce the tax liability attributable to investment activities and to operations from dealings with outsiders. The after-tax earnings are being used to reduce amounts charged to the tenant stockholders for the expense of maintaining cooperative property. In essence, this income is being used to provide an economic benefit to the tenant stockholders. Theoretically that could be construed as a dividend to the tenant stockholders; but it is the prevailing practice, as we understand it, for cooperative housing corporation tenant stockholders to claim not to have received a taxable dividend, though the authority for that position is rather unclear.

Under the 80-percent rule, the cooperative have 80 percent of its income from dealings with tenant stockholders, as stated differently, their outside income cannot exceed 20 percent. This rule operates in an indirect fashion to limit the extent of this problem. And we think the 80-percent rule is a good rule.

Tenant stockholders receive additional tax benefits. They are eligible for tax-free rollover treatment if they sell their stock in a cooperative apartment and roll it over into a residence. If the percentage of gross income permitted to be derived other than from tenant-stockholders were increased from the 20 percent to 50 percent, as proposed by this bill, we would have a problem with those additional benefits being available to investment activities or to outside business activities.

It is true, as the commentators have suggested, that the 80-percent test does make it necessary for cooperative corporations to limit their income from outside sources and, thus, sometimes, to lease property at below market value so they don't run afoul of the 20-percent test. That is going to be a problem if you increase the 20 percent to 50 percent. It will be a problem wherever the margin is. We are sympathetic with that problem and we will be happy to work with the committee staff if there is any way to solve it. But we do not think that simply reducing that 0 percent to 50 percent is an appropriate method of doing so.

We basically think that tenant stockholders should be treated as favorably as homeowners, but not more favorably than homeowners.

Finally, the other provision of the bill would affect the treatment of original sellers, who under current law will be treated as tenant-stockholders in a cooperative corporation for a maximum of three years. The 3-year limitation would be removed by S. 1764, and there would be no limitation on the period of time in which the original seller could hold the stock.

We would object to doing away with the 3-year period altogether, but we would not object to alleviating the specific problems that the 3-year limitation might cause. For example, where a proprietary lease is subject under rent control to the right of an existing tenant to remain in the residence in question for a period that might extend beyond three years, we would not have a problem with dealing with that type of situation, specifically.

Mr. Chairman, that concludes the summary of our position.

Senator PACKWOOD. Mr. Secretary, thank you very much.

Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman.

Mr. Secretary, on S. 1749, the present law attempts to prevent any reduction in tax arising from the payment of foreign bribes. Now, does S. 1749 permit the deduction in regard to the payment of foreign bribes?

Secretary CHAPOTON. S. 1749 would make it clear that there would be no disallowance of deduction if the payment were not in violation of the law of the country where the payment is made.

Senator BYRD. Do you mean that if a deduction is not in violation of the law it would be allowed.

Secretary CHAPOTON. The deduction would be allowed if it is in violation of the law of the country.

Senator BYRD. Specifically, does it permit a deduction for the payment of a foreign bribe? Does it permit that to be deducted?

Secretary CHAPOTON. In some cases it would permit the deduction of a payment which would be a bribe under U.S. law. Yes, sir. And, it might permit a deduction in some cases where the bribe was illegal under the law of the country in which the payment was made.

Senator BYRD. Well, that never occurs.

Senator CHAFEE. Let me just say something, if I might. I am quite familiar with this. The presently existing Foreign Corrupt Practices Act—which is up for change, but never mind that—the existing Foreign Corrupt Practices Act, which is as tough and stiff as anything we ever dreamed up, does permit what they call "facilitating payments" abroad. In other words, if in the course of doing business overseas you make a payment to a customs agent to facilitate or expedite the processing of a customs document, that payment is legal under the Foreign Corrupt Practices Act. However, under section 162(c) of the Internal Revenue Code, you could not deduct that payment because such a payment would be illegal if made in the United States.

Senator BYRD. Yes. I understand.

Senator CHAFEE. So what we are trying to do is to permit the payments that are legal under the Foreign Corrupt Practices Act to be deductible.

Senator BYRD. I understand that, and I have sympathy with it, but I just want to understand how far reaching what you are seeking to accomplish is or it may be.

But as I understand from what you say, Mr. Secretary, S. 1749 would permit deductions for payments of foreign bribes under certain conditions.

Secretary CHAPOTON. The answer to that is, yes. If the payment had been made domestically, in certain circumstances no deduction would be permitted because it would be illegal.

Senator BYRD. Now the present law makes it illegal for U.S. citizens or agents to make or authorize either directly or indirectly payments to foreign government officials, foreign political parties, foreign political candidates, if the intent of influencing official action is in order to obtain business.

Now does this legislation before the committee now permit a deduction under those conditions?

Secretary CHAPOTON. It would permit a deduction if that were not an illegal act under the law of the country. Yes, sir.

Senator BYRD. On another subject, what is your estimate as of today of the fiscal year 1982 deficit?

Secretary CHAPOTON. Our fiscal year 1982 deficit?

Senator BYRD. Correct.

Secretary CHAPOTON. $43 billion.

Senator BYRD. In your judgment, is that what you consider an accurate estimate?

Secretary CHAPOTON. That estimate is currently being reviewed. Do you mean the entire Government's deficit for 1983 without regard to this?

Senator BYRD. For 1982.

Secretary CHAPOTON. I mean it is fiscal year 1982 without regard—you are not relating to this amendment specifically?

Senator BYRD. No, I am shifting ground. I am talking now only about the deficit.

Secretary CHAPOTON. The accuracy of the fiscal year 1982 deficit is now being reviewed in depth by the Office of Management and Budget and by the Treasury Department. That is the mid-session review and estimate. And, Senator, I would have to say that we are reviewing it, and that there might likely be some change in that estimate, but we are not ready to state what we think that change might be yet.

Senator BYRD. Well, I am trying to ascertain the accuracy of the $43 billion. The news accounts indicate that it will be substantially above that. Is that your view as Assistant Secretary?

Secretary CHAPOTON. It may well be substantially above that because, as you know, interest costs now appear to be higher, at least in the first part of fiscal year 1982, than were originally projected. Receipts will probably be down to some extent because of the recession that we appear to be entering now. So my estimate would be, yes, it will be somewhat higher than that, but the amount by which it would be higher, I could not state specifically.

Senator BYRD. What is your estimate of the deficit for fiscal year 1984, which is a critical year?

Secretary CHAPOTON. Well, under the mid-session review, which is the latest estimate we have released, there is no deficit. There is a 0.5 surplus in fiscal year 1984. But for a number of reasons, of course, that estimate is based on the reduction in budget outlays as stated in the mid-session review, some of which, apparently, will not be obtainable now, that will not be enacted by Congress, and because of the possibility of lower receipts due to a variety of factors there will possibly be a deficit and maybe a significant deficit without further policy changes.

But we are reviewing that now, so I simply could not state positively what the projection will be.

Senator BYRD. I feel there must be a balanced budget by 1984. I feel there can be a balanced budget by 1984. Do you agree or disagree with my assertion?

Secretary CHAPOTON. I think a balanced budget in 1984 is extremely desirable. Whether there can be or cannot be, I could not state with certainty at this time, Senator.

Senator BYRD. Do you have disagreement with my view that the budget can be balanced in 1984?

Secretary CHAPOTON. We thought earlier this year, of course, without question, that that would be possible. I would have to state now, as I review the numbers, that depending on congressional action, and by that I mean principally the failure to reduce outlays as requested in the President's program, the balanced budget may not be obtainable.

Of course, if the outlay reductions are obtainable, a balanced budget can be achieved in 1984.

Senator BYRD. In other words, if the Congress will do what the President recommends in regard to spending reductions, then the budget can be balanced in 1984?

Secretary CHAPOTON. That is undoutedly correct. Yes, sir.

Senator BYRD. Now let me get on another subject, and that is in regard to the leasing provisions of the 1981 tax legislation.

I didn't have the time to read the details this morning of two large corporations each of which would benefit to the extent of somewhere between $100 and $300 million as a result of that leasing provision.

What is the Treasury's position on that leasing provision?

Secretary CHAPOTON. Senator, we feel very strongly that the leasing provision is an essential element of the accelerated cost recovery system adopted by the Congress, pursuant to our proposal.

The recent provision is being misunderstood. It does not make a nonprofitable investment by a company profitable. It means only that a company that does not have the ability to use currently the deductions and the credits available from an investment will be able to obtain most of those benefits through a leasing transaction, and thus have the same or nearly the same incentive to invest as a company that does have current tax liability sufficient to utilize the deductions and credits.

But I want to emphasize it does not give an incentive, as one would be led to believe by reading some of the news accounts, to make a totally unprofitable investment.

Senator BYRD. But the administration favors the leasing provisions.

Secretary CHAPOTON. Yes, sir. Strongly.

Senator BYRD. Let me ask you this: Could you give an example now of how that leasing arrangement works? There was very little discussion, as I recall, in the committee when the tax legislation, was before this committee, and I am not sure whether it was an administration proposal or how it got into the bill. Would you give some history on that?

Secretary CHAPOTON. Yes, sir.

Senator, it was an administration proposal. Let me give a little history.

When you have inflation that is decreasing the value of deductions for depreciation, then you are overstating income—corporations, let's say, or anybody who has depreciable equipment—the income is overstated. Congress has responded by accelerating the deductions and the credits to an earlier period of time which has the effect of giving greater benefits in reduction, in taking out some of the impact of inflation.

The result, as you accelerate these deductions, is that they are of less benefit to a corporation which cannot fully utilize the accelerated deductions. When we accelerated the deducations under the latest proposal, we exascerbated that problem. In attempting to solve one problem, we exascerbated the problem of disparity between corporations, because there are startup corporations or cyclical corporations that cannot utilize the deduction.

Senator BYRD. Well, give us an example how the Ford Motor Co. and IBM benefit from this.

Secretary CHAPOTON. Well, the Ford Motor Co., if it does not have currently taxable income, it could buy machinery. It would finance that machinery under traditional sources. It will, again, enter into a sale of the machinery for tax purposes, a sale of the machinery to IBM, if IBM has taxable income, and an immediate lease of the equipment or the machinery back from IBM, so that IBM for tax purposes would be treated as the owner. When the machinery is placed in service, IBM would claim accelerated deductions and investment tax credit for the equipment.

IBM would pay an amount to Ford in this transaction. The amount would be based on the value of those deductions and credits to IBM. The effect would be to reduce to that extent the cost of that equipment to Ford, so Ford would then have equipment reduced in cost by almost the same amount—not quite, but almost the same amount—as the cost would have been reduced had it been able to utilize the deductions and credits.

Then for tax purposes IBM would be treated as the owner, would claim the credit against its tax liability, and will claim a stream of deductions against its future income as the depreciation deductions from that equipment in the current and future years arise.

Senator BYRD. And IBM would get the investment tax credit?

Secretary CHAPOTON. IBM would get the investment tax benefit.

Senator BYRD. And this was an administration proposal?

Secretary CHAPOTON. It was the administration's. I got sidetracked just a bit in my description of it.

We were concerned that when you accelerate these deductions you have a problem, a disparity between companies that can and cannot utilize them; you have potential takeover threats, that is, acquisitions solely to obtain these new tax benefits, unless we relieve the system in some way.

The prior law allowed leasing transactions, but there were very severe restrictions on the ability to do so. One of the principal restrictions was that there had to be a fair-market value of the purchase of the equipment at the expiration of the lease, which ends up with an airline, for example, buying back a 747 from the bank at the end of the 15-year lease at its then fair market value. These new rules simply say that you could have a dollar purchase at the end of the lease. So it is a modification of a prior law leasing rules.

Senator BYRD. Thank you very much.

Secretary CHAPOTON. Thank you.

Senator PACKWOOD. One very quick question, Mr. Secretary, on 1749.

Basically this is just a "when in Rome" kind of law, as I understand it.

Secretary CHAPOTON. That is basically correct.

Senator PACKWOOD. And if, indeed, payments under Italian law is not a fraud, it would be a deduction here.

Secretary CHAPOTON. That is correct; plus, Mr. Chairman, the present law has a great deal of uncertainty because it is difficult to tell whether a particular payment is a violation of U.S. law.

Senator PACKWOOD. What do you do in a situation where, no matter what the foreign law is, the custom and practice is the violation of it, and it is flagrantly violated by everybody in the country domestically and nobody pays any attention to it and nobody is prosecuted, but the payment indeed, technically, violates the law?

Secretary CHAPOTON. It would still be not allowed as a deduction under this provision if it was considered an improper payment by our standards.

Secretary PACKWOOD. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Secretary, I see the press is here, and I just don't want any misunderstanding to go out of this room through the press that what we are doing under this provision of 1749 is to allow the deductibility of bribes. What this provision says is, if we pass this provision, if the payment is legal under the Foreign Corrupt Practices Act it is deductible. The only foreign payments which are legal under the act are facilitating or grease payments which are payments to low-level officials for ministerial kinds of activities such as the processing of customs entry documents.

So I don't want any misunderstanding that we are suggesting that we are allowing the deductibility of bribes. We are not. We are allowing only what is permissible under the Foreign Corrupt Practices Act. Is that not correct, Mr. Secretary?

Secretary CHAPOTON. That is generally correct, Senator Chafee, and I should emphasize that. If a payment violates U.S. standards of what is an improper foreign payment and violates foreign law it is not deductible, under S. 708. S. 1749 and S. 708 make the tax law completely consistent with the restrictions under the Foreign Corrupt Practices Act.

Senator CHAFEE. Thank you.

Mr. Chairman, I have a statement that I would like to submit and also a statement from the Emergency Committee for American Trade, which is composed of some 650 U.S. companies doing business overseas and who are in support of this amendment to the Internal Revenue Code.

Senator PACKWOOD. They will both be placed in the record.

Senator CHAFEE. Thank you very much.

[The prepared statements follow:]

STATEMENT BY SENATOR JOHN H. CHAFEE (R-R.I.)

My bill to amend Section 162(c) of the Internal Revenue Code is intended to harmonize the provisions of the Tax Code with U.S. law regarding expenditures made by companies in the course of doing business abroad.

Section 162(c) provides that payments to an official or employee of a foreign government, which would be unlawful under U.S. laws if such laws applied, are not deductible. This provision was enacted as part of the Tax Reform Act of 1976 prior to the enactment of the Foreign Corrupt Practices Act. The Act was intended to promote corporate morality in the wake of the reports that Lockheed, Gulf and a number of other American corporations had systematically tried to corrupt foreign governments with bribes and other illegal payments. The idea was to deter bribery overseas by denying certain tax benefits to American companies who bribed officials of foreign governments.

One year after the Tax Reform Act was passed, Congress enacted the Foreign Corrupt Practices Act which made the payment of bribes to foreign officials a crime but also provided that if the payment is to a person performing a ministerial duty such as the processing of entry documents by a customs official, it is not prohibited.

The problem is that when Congress enacted the Foreign Corrupt Practices Act, it did not bring the Internal Revenue Code into step with the Act.

The Foreign Corrupt Practices Act allows facilitating or grease payments in the context of overseas transactions such as payments to customs officials even though such payments would be illegal if made in the United States. Nonetheless, the Tax Code does not allow a U.S. company to deduct such payments. This means additional bookkeeping requirements for companies doing business overseas and if means that companies are subject to a punitive measure even for acts which are legal under the law which governs payments to foreign officials.

This amendment is part of my effort to eliminate the export disincentives caused by the ambiguities in the Foreign Corrupt Practices Act. I introduced a bill in March of this year, S. 708, which proposes modifications in the accounting and antibribery provisions of the Act.

It does not make sense to penalize U.S. companies by denying them tax benefits with regard to payments made overseas which are legal under the Foreign Corrupt Practices Act. The Act is the embodiment of Congressional intent as to the sanctions that should be imposed upon U.S. companies who make illegal overseas payments. Section 162(c) of the Tax Code is at cross-purposes with that statement of intent and should, therefore, be amended.

I. INTRODUCTION

The Emergency Committee for American Trade ("ECAT") is an organization of the leaders of 63 large U.S. firms with extensive overseas business interests. ECAT member companies had 1980 worldwide sales of nearly $600 billion and employed over five million people. The companies are major U.S. exporters. They contribute signifiently to the U.S. exporters. They contribute significantly to the U.S. balance of payments both through their exports and through the profits earned by their foreign affiliates and joint ventures.

The absence of an express scienter requirement in Section 102 exposes American business to potential criminal liability for unintentional—even inadvertent—errors in the company's books. S. 708 would make clear that Congress intended Section 102 of the FCPA to be framed in terms of the very abuses that were revealed, i.e., knowing falsification of books and knowing circumvention of internal accounting controls. Congress did not have before it in 1977 nor does it have at present any showing of a need for imposing criminal liability for unintentional failure to meet the statute's recordkeeping and accounting standards.

ECAT also supports the other changes in Section 102 that S. 708 proposes. These include the amendment that defines the good faith obligation of an issuer for the recordkeepong and internal accounting controls of a domestic or foreign firm in which the issuer holds 50 percent or less of the equity capital.

6. Amending Section 162 of the Internal Revenue Code To Conform to the FCPA.

Section 162(c)(1) of the Internal Revenue Code was enacted long before the disclosures of the mid-1970's that led to enactment of the FCPA. In an approach which is virtually unprecedented under U.S. law, Section 162 calls for hypothetically applying U.S. law to a payment made to a foreign governmental official. The tax law denies a deduction for such a payment if it "would be unlawful under the laws of the United States if such laws were applicable to such payment and to such official or employee." section 1065 of the Tax Reform Act of 1976 provided for other adverse tax consequences for payments which meet this Section 162 test and which are made to foreign government officials by foreign corporations controlled by a U.S. taxpayer or by a DISC.[1]

With the enactment of the FCPA, the rationale no longer exists for using the hypothetical approach of Section 162(c)(1). U.S. law now includes an actual statutory prohibition against foreign governmental bribery. we believe that the standard of that prohibition—and no other—should govern whether a U.S. taxpayer is penalized under U.S. tax law for making an improper payment. Otherwise, U.S. business is forced to implement two separate standards in respect of the same situation. In fact, ECAT members are being forced to apply just such a dual approach in the case of facilitating or expediting payments. Such payments are not proscribed by the FCPA, but they would usually be unlawful if made in the United States to U.S. governmental officials. As a result, the adverse tax consequences are applied to these overseas payments even though they are entirely lawful under the FCPA.

S. 708 would correct this anomalous situation by conforming Section 162(c)(1) to the terms of the FCPA. ECAT members urge adoption of this practical approach which would establish a uniform standard and, consequently, eliminate a good deal of unnecessary recordkeeping.

III. OTHER PROVISIONS OF S. 708

The Chafee bill proposes a number of other significant improvements in the FCPA which ECAT members support. These include the amendments relating to procedural points such as the unification of civil and criminal enforcement jurisdiction in the Department of Justice, the strengthening of the responsiveness and confidentiality of the Business Review Procedure, and the requirement that the Administration address the international competitive problem that U.S. business faces with a view to formulating policy and legislative responses. We support approval by Congress of these provisions in S. 708.

We appreciate this opportunity to present the views of ECAT members on this important legislative issue. Until S. 708 is enacted into law, American business will continue incurring the needless costs that result from the application of those provisions of the FCPA that Senator Chafee has addressed. The changes proposed by S. 708 will help to eliminate the unnecessary competitive disadvantage that U.S. industry faces in developing American exports and foreign investment. Accordingly, we urge prompt and favorable action on Senator Chafee's initiative.

Senator PACKWOOD. Senator Symms.

Senator SYMMS. Thank you very much, Mr. Chairman. And I apologize that I was tardy to the meeting. I missed part of the Secretary's testimony.

But, scanning through it, Mr. Secretary, I see with relation to S. 1594 that you asked for more time to study it. How long do you think you need?

Secretary CHAPOTON. Senator, I would hate to put an absolute time constraint on a review of this. As I said in my written testimony and as I said orally, there is considerable appeal to the proposed amendment, which obviously attempts to make the penalty fit the crime. But there is a feeling within many sectors of Government that we would be severely undermining the impact of the civil fraud penalty to the detriment of our system. I note that the present law, which applies the penalty to the entire deficiency over the year, has been the law since 1918. While that alone is not reason to keep it, we just want to make sure we are not undermining the system.

[1] Specifically, the 1976 amendments provided that a payment by a controlled foreign corporation falling within the terms of Section 162(c)(1) would be included in Subpart F income and not be deductible in calculating Earnings and Profits under I.R.C. Section 952. for DISCs, payments within Section 162(c)(1) are treated as a "deemed distribution" to the U.S. shareholder. 26 U.S.C. §§ 952(c)(4), 964(a) and 995(b)(1)(iii), Sec. 1065 of Pub. L. No. 94-455, 90 Stat. 1653.

That is a long way of saying I would like a matter of weeks, in any event, to file a statement with the subcommittee.

Senator SYMMS. Thank you very much. I might just say and you might notice on our witness list this morning that we will have some very distinguished witnesses on the bill, and I would encourage you to take their testimony down for your attorneys to study what it is that the American Bar Association and others are saying about this bill. Senator Curtis, among others, will be testifying.

Secretary CHAPOTON. We certainly will do that.

Senator SYMMS. All right.

Thank you, Mr. Chairman.

Senator PACKWOOD. Thank you.

Any further questions?

[No response.]

Senator PACKWOOD. Mr. Secretary, thank you very much.

[The prepared statement follows:]

Lack of time has prevented OMB from advising on the relationship of this testimony to the program of the President.

<u>For Release Upon Delivery</u>
Expected at 9:00 A.M. EST

STATEMENT OF JOHN E. CHAPOTON
ASSISTANT SECRETARY FOR TAX POLICY
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE
November 6, 1981

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the following bills: S. 1081, relating to self-insurance set-asides of design professionals; S. 1594, relating to the civil fraud penalty; S. 1749, relating to deductibility of payments under the Foreign Corrupt Practices Act; and S. 1764, relating to cooperative housing corporations.

After setting out a summary and the position of the Treasury Department with respect to each bill, I will discuss each proposal in detail.

Summary

S. 1081 would permit architects, engineers and other design professionals to deduct currently amounts paid into a tax-exempt self-insurance trust established to fund liabilities attributable to negligence or breach of warranty. The annual deduction could not exceed $100,000 in the case of a taxpayer with a "severe service liability insurance problem" or $25,000 in the case of other eligible taxpayers. The Treasury opposes S. 1081.

S. 1594 would increase the civil fraud penalty from 50 to 100 percent, but would limit that penalty to the portion of the underpayment attributable to the taxpayer's fraud. Additionally, the bill would shift the burden to the taxpayer to prove that portions of an underpayment are not fraud-related once the Government has established that a portion is attributable to fraud. The Treasury respectfully requests the opportunity to study this bill further.

S. 1749 would amend Code section 162(c)(1) to disallow a deduction for a payment to an official or employee of a foreign government if the payment would be unlawful under the Foreign Corrupt Practices Act of 1977. The Treasury supports this amendment.

S. 1764 would relax the rules for determining whether a corporation qualifies as a "cooperative housing corporation." The Treasury opposes S. 1764.

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S. 1081--Deduction for self-insurance set-asides for liabilities of design professionals

S. 1081 would amend Code sections 165 and 501 to provide both current deductions for contributions to certain professional liability self-insurance accounts, and a tax-exemption for interest earnings on such trust accounts. The bill, which applies only to malpractice insurance funds for architects, engineers, and "design professionals," provides separate deduction limitations for design professionals in general and for those professionals having "severe service liability insurance problems." These limitations permit the deduction of up to either $100,000 for any architect or engineer faced with insurance premium quotations exceeding 2 percent of annual gross receipts, or

$25,000 for all other eligible taxpayers. Authorized distributions from any account are included in the taxpayer's gross income, but are not treated as insurance compensation for purposes of figuring the allowable deductions under section 165. A 10 percent penalty tax is imposed on unauthorized distributions, to insure that proceeds of the account are used only for paying liabilities attributable to negligence, structural defects, or breach of warranty in the taxpayer's work. This 10 percent penalty tax would not apply, however, to corrective withdrawals of excess contributions, to the dissolution of any account which, due to a change in circumstances, is no longer needed, or to roll-overs, liquidations, or deemed distributions.

The Treasury opposes S. 1081.

The argument most frequently raised in support of this proposal is that the tax law currently discriminates in favor of commercial insurance and against self-insurance, because commercial insurance premiums paid in the ordinary course of business are deductible, while contributions to a self-insurance trust are not. A careful analysis of the tax treatment of malpractice liability indicates, however, that this argument is incorrect. Although the analysis is extremely complex, it is our conclusion that the tax treatment of self-insured and commercially insured losses is essentially symmetrical. Indeed, the present value of the deferred deduction to the self-insurer may, in some circumstances, actually exceed the benefit obtainable for a current deduction of commercial insurance premiums.

The combination of the tax deferral on interest accumulations and the lack of correlation between the size of the self-insurance funds and actual losses gives rise to the revenue loss estimates for this proposal. Because self-insurance is inherently inefficient when compared to commercial insurance, any self-insurance set-asides rarely correspond to contingent design liability losses.* The inherent inefficiency of self-insurance stems from the fact

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*Generally accepted accounting principles do not permit a deduction for contingency reserves. Statement 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.

that the self-insured party must by definition put aside $1 of capital for every dollar of risk insured. Because, by contrast, commercial insurance involves the pooling of covered risks among insured parties and over time, the amount of capital required per dollar of coverage is significantly smaller. The frequent disparity between amounts set aside by self-insurers and the size of actual losses is further increased by the difficulty in accurately predicting the magnitude of professional design liability risks.

The Treasury has estimated that S. 1081, because of the foregoing factors, would reduce budget receipts by $22 million in fiscal year 1982, $58 million in fiscal year 1983, $67 million in 1984, $72 million in 1985, and $76 million in 1986. This estimate does not even take into account the fact that the bill as drafted would permit tax-free accumulation of interest earnings on unlimited amounts of nondeductible contributions to these self-insurance reserves.

The final tax policy ground for opposing this proposal is based upon the inequity in the incidence of benefits. The benefits of deferral increase with the marginal tax rate of the taxpayer and the period of time for which taxes are deferred.* Thus, taxpayers benefitting the most from S. 1081 would be those in the highest brackets, who leave their funds on deposit for the longest periods of time. Logically, these taxpayers are likely to incur proportionately less design liability losses than smaller firms, or firms incurring frequent service liability losses. If the purpose of this legislation is to make commercial insurance cheaper or easier to obtain, the tax deferral mechanism is hardly the appropriate way to achieve this goal, because it fails to channel the benefits to the smaller, harder-to-insure firms who need the legislation the most.

Finally, I would like to turn to three technical problems with S. 1081.

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*The lack of any annual minimum funding standards in S. 1081 increases the likelihood that patterns of irregular contributions will develop, whereby firms would set aside monies only in profitable years.

First, although the bill limits the deductibility for annual contributions to a tax-exempt professional liability trust, it sets no limit on nondeductible contributions, which would of course be allowed to accumulate in the trust free of tax. Moreover, because the rule in the bill permitting penalty-free withdrawal of nondeductible contributions does not require the withdrawal of interest on such contributions, the taxpayer would never be required to pay taxes on its earnings, to the extent that these amounts are applied to cover design liability losses.*

The second technical objection is that, unlike any predecessor bills dealing with product liability self-insurance accounts,** and unlike the exemption currently applicable to Black Lung Benefits Self-Insurance Trusts under Code section 501(c)(21), S. 1081 does not set any limits on permissible investments of the assets of exempt set-aside trusts. All prior self-insurance bills and section 501(c)(21) generally require that the assets of these independently trusteed, segregated accounts be invested only in Federal, State, or local debt securities or instruments of deposit in a financial institution. S. 1081 vastly expands the realm of permissible investments to "any other asset [other than the capital stock of the taxpayer] which . . . is a permissible subject for investment" by trust fiduciaries under applicable State law.

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*The rules of Code sections 408(d)(4) and 408(f), applicable to the excess contributions to IRAs mandate the return of nondeductible contributions, plus any "net income attributable to such excess contribution." Such interest is both included in income and subjected to a 10 percent penalty tax in the year in which the excess contribution was made.

**See, e.g., S. 3049, S. 1611 and H.R. 10272, considered during the 95th Congress.

Treasury's final technical objection to S. 1081 is that it lacks sufficient restrictions on improper expenditures, self-dealing, or reversion of funds to the taxpayer. Acceptable restrictions had appeared in prior bills on product liability self-insurance accounts, and currently exist in Code section 501(c)(21). These other self-insurance provisions require, as a condition for exemption of income earned on set-side funds, that no part of the trust assets can possibly revert to the taxpayer, other than for payment of the taxpayer's service liability losses. S. 1081 merely provides, in new Code section 165(1)(10)(D)(iii), an organizational restriction that the "exclusive purpose" of the trust be to satisfy the taxpayer's service liability losses. The significant omission is any operational restriction, stating that no part of the trust assets can be used for, or reverted to, any purpose other than the stated organizational purposes. Admittedly this omission eliminates most of the extremely complex administrative accounting required under prior bills in order to define the appropriate tax treatment to be applied to nonqualifying distributions from, or liquidations of, such product liability loss reserve accounts. However, by providing that all amounts distributed from the account must be subject only to income tax, S. 1081 offers tax deferred benefits to a firm which establishes a professional liability reserve account and, after a number of years, proves that circumstances have changed and it no longer needs the account. Such a taxpayer would thus be in a far better position than if it had never established the trust.

S. 1594--Increase in Civil Fraud Penalty and Limitation to Portion of the Underpayment Attributable to Fraud

Under present law, a civil penalty is imposed where a taxpayer fraudulently attempts to underpay his taxes. The penalty is generally 50 percent of all additional taxes owed. In a civil fraud case, the Government has the burden of proof. S. 1594, on the one hand, would increase the penalty from 50 to 100 percent, but would also limit that penalty to only the portion of the underpayment attributable to the taxpayer's fraud. Additionally, S. 1594 provides that, where the Government establishes in a court proceeding that a portion of an underpayment is due to fraud, the burden shifts to the taxpayer to prove that other portions of the underpayment are not due to fraud.

S. 1594 would make major changes to the present civil fraud penalty and presents many difficult questions of tax administration. Accordingly, the Treasury respectfully requests the opportunity to study this matter further. At the completion of our study, we will be pleased to submit our views to the Subcommittee for the record.

In examining S. 1594, we first note that the present rule has had a long history. Since the Revenue Act of 1918 the fraud penalty has been applied to the entire tax underpayment. Indeed, prior to 1918, the penalty rate was 100 percent and applied to the taxpayer's total tax liability, not only to the underpayment. However, longevity alone would not support retention of current law, and we must therefore examine the role of the present civil fraud penalty in our tax system and whether S. 1594 would inappropriately change that role.

One significant purpose of the present rule is to deter taxpayers from willfully underpaying their taxes. In this respect, the civil fraud penalty is an important complement to the criminal penalties since in many cases it is simply impractical to seek criminal sanctions.

We fear that restricting the civil fraud penalty, as proposed by S. 1594, to only the portion of the underpayment attributable to the fraud could reduce its deterrent effect. Since successful tax evasion presents a threat to our self-assessment system, we strongly believe that the IRS tools in this area, such as the civil fraud penalty, should not be weakened.

We also recognize, however, that the present fraud penalty operates inequitably and capriciously in some circumstances. Thus, taxpayers with similar amounts of income, or similar fraudulent items, may have substantially differing penalties depending on the existence of other deficient, nonfraud tainted, items on their returns. We also recognize the logic in the argument that the "penalty should fit the crime"; that a substantial penalty should not result where the taxpayer has been fraudulent with respect to a relatively minor item. We note too that it has been argued that the present structure impedes the settlement of cases and that, where the penalty is disproportionately large, the Service and the courts are reluctant to impose it.

Accordingly, the critical question for us is whether the present inadequacies of the penalty, and the gains to be derived from changing it, are sufficient to overcome the risks of eroding its deterrent effect.

Another important consideration is the impact of the proposal on the practicalities of litigating a fraud case. Under present law, the Government has the burden of proof and must establish its case by clear and convincing evidence. The courts have generally applied this standard very strictly. Additionally, it is very difficult to prove whether a particular part of a deficiency is attributable to fraud. Accordingly, the Government generally proves its case by circumstantial evidence which establishes a pattern of fraudulent conduct. If the Government were instead required to prove that specific items were fraudulent, the difficulty of meeting this burden would render the penalty meaningless. We understand that it is the intent of S. 1594 that, once the Government has established that even $1 of a deficiency is attributable to fraud, the taxpayer would have the burden of proving the negative -- that the other amounts of the deficiency are not fraud-related. We think this shift of the burden of proof is a crucial element of this proposal. It must also be recognized, however, that, even with a shift of the burden, the change of focus from a pattern of conduct to a specific items approach will greatly complicate and lengthen trials involving fraud issues.

Finally, we wish to point out some of our other concerns. For example, as noted by the Supreme Court (Helvering v. Mitchell, 303 U.S. 391 (1938)), a purpose of the present fraud penalty is to reimburse the Government for the expense of investigating and collecting the evaded tax. If liability were limited to only the fraudulent items, this role would be diminished. Additionally, while not an issue in this bill, the present negligence penalty, like the fraud penalty, also applies to the entire amount of the tax underpayment. Limitation of the fraud penalty would undoubtedly lead to arguments that the negligence penalty should similarly be restricted. Finally, limiting fraud to specific items would present numerous administrative difficulties which we are now in the process of evaluating.

As is evident, S. 1594 presents significant problems. By the same token, however, there is appeal to its approach. Thus, we appreciate the opportunity to make a full study of this matter and report back to the Subcommittee.

S. 1749--Deductibility of payments under the Foreign Corrupt Practices Act

S. 1749 would amend Code section 162(c)(1) to disallow a deduction for a payment to an official or employee of a foreign government if the payment would be unlawful under the Foreign Corrupt Practices Act of 1977. We support this amendment.

The purpose of S. 1749 is perhaps best understood by noting that it is but a small part of proposed legislation, S. 708, which would modify the Foreign Corrupt Practices Act. The Foreign Corrupt Practices Act of 1977 currently provides, in part, that it is unlawful for certain U.S. persons to use the mails or interstate commerce corruptly in furtherance of an offer to give anything of value to a foreign official to influence his or his government's actions in order to further the business of the U.S. person. One of the proposed modifications contained in S. 708 would limit the application of the Act to practices that violate the law of the other country in question. The Administration has already testified in favor of S. 708.

Code section 162(c)(1) now provides, in relevant part, that income tax deductions are not allowed for any payment made to an official or employee of a foreign government if the payment would be unlawful under the laws of the United States if such laws applied to such payment and to such official or employee. If a payment would be unlawful under the laws of the United States, a deduction is disallowed under Code section 162(c)(1) without regard to whether the payment is lawful or unlawful under the laws of the foreign country.

Making an illegal payment within the meaning of Code section 162(c) adversely affects taxpayers under other Code provisions. Thus, a section 162(c) illegal payment made by or on behalf of a controlled foreign corporation does not reduce the earnings and profits of the corporation and causes the inclusion of subpart F income to the corporation's U.S. shareholders. Also, a section 162(c) illegal payment reduces the tax deferral benefits of the Domestic International Sales Corporation ("DISC") provisions of the Code.

If Code section 162(c)(1) were amended as proposed in S. 1749, there would be one definition of prohibited payments for both the Code and the Foreign Corrupt Practices Act. This consistent treatment would simplify and improve current law, as different definitions presently apply for tax and non-tax purposes. S. 1749 would also provide taxpayers with greater certainty. The current definition in section 162(c)(1) is vague and encompasses payments which would not violate the Foreign Corrupt Practices Act. Moreover, if S. 708 were also enacted, it would narrow the type of payments resulting in the disallowance of income tax deductions, the creation of subpart F income and a reduction in DISC benefits.

<u>S. 1764 - Cooperative Housing Corporations</u>

S. 1764 would amend the provision of the Internal Revenue Code relating to the taxation of stockholders of cooperative housing corporations in two respects. First, it would reduce the percentage of gross income that must be derived by a cooperative housing corporation from tenant-stockholders from 80 percent to 50 percent. Second, it would eliminate the three year limitation on the period during which an original seller holding stock in a cooperative housing corporation will be treated as a tenant-stockholder. The Treasury Department opposes S. 1764.

Under current law, a tenant-stockholder in a cooperative housing corporation is entitled to deduct amounts paid to the corporation representing his or her proportionate share of the corporation's allowable real estate taxes and interest relating to the corporation's land and buildings. In addition, a tenant-stockholder is entitled to deduct an allowance for depreciation to the extent that the tenant-stockholder's leasehold interest is used in a trade or business or for the production of income. These deductions are available only if the corporation owning legal title to the relevant property qualifies as a cooperative housing corporation. One of the conditions for qualification is that at least 80 percent of the gross income of the corporation be derived from tenant-stockholders.

These provisions were enacted to place tenant-stockholders of a cooperative housing corporation in virtually the same tax posture as if they had purchased their interest in the property directly. This remains a sensible goal. If the cooperative only conducted business with its tenant-stockholders, there would be few, if any, problems.

Unfortunately, cooperatives have a dual nature: in addition to performing services for their tenant-stockholders, they also engage in investment activities and in business transactions with "outsiders." The proper taxation of cooperatives requires that this dual nature of cooperatives be adequately considered. In particular, it is necessary to make sure that the income derived from the investment activities and from the operation of a trade or business with outsiders by the cooperative housing corporation be taxed in a comparable fashion to income earned by a corporation.

Currently, cooperative housing corporations are being availed of to reduce the tax liability attributable to investment activities or to the operation of a trade or business with outsiders. The after-tax earnings of the cooperative housing corporation are being used to reduce the amount charged by the cooperative to its tenant-stockholders for the costs of maintaining the cooperative's property. In essence, the after-tax profits properly allocable to the noncooperative activities are being used to provide economic benefits to the tenant-stockholders. If the income were earned by a noncooperative corporation, this type of benefit would be clearly taxable to the corporation's stockholders as a dividend. However, it is the prevailing practice in the case of cooperative housing corporations for the tenant-stockholders to claim not to have received a taxable dividend, although the authority for this position is at best unclear. This practice may have resulted from the practical difficulties of the IRS in determining whether a dividend has occurred. Although it works in an indirect fashion, the 80 percent requirement effectively limits the extent to which the earnings allocable to the noncooperative transactions may be used to provide nontaxable benefits to the cooperative's stockholders.

In addition, the tax law provides other benefits to the owners of cooperative housing corporations. For example, a taxpayer selling stock in a cooperative housing corporation may "rollover" any gain on the stock of the cooperative housing corporation if the conditions of section 1034 are satisfied. Similarly, a tenant-stockholder would be entitled to the one-time exclusion of gain from the sale of a principal residence if the conditions of section 121 are satisfied. In each case, a portion of the gain deferred or excluded may be attributable to the tenant-stockholder's investment in the noncooperative operations of the cooperative housing corporation. Since the 80 percent requirement limits the extent of the noncooperative activities, these extra benefits available to tenant-stockholders are limited. However, the change proposed by S. 1764 would increase these unjustified tax benefits.

Some commentators have argued that cooperative housing corporations have been forced to enter into commercial transactions on less than optimal terms to avoid the possibility of running afoul out of the 80 percent requirement. For example, it has been asserted that commercial space will be leased at less-than market rental rates. While we are sympathetic to this problem, we believe that the proposed remedy, i.e., to reduce the portion of gross income that must be derived from tenant-stockholders from 80 to 50 percent, is inappropriate. This remedy would increase the unjustified tax benefits that the tenant-stockholders of a cooperative housing corporation presently receive. We would be happy to work with this Committee and its staff to produce some alternative method of resolving this problem.

As was stated earlier, we believe that tenant-stockholders of a cooperative housing corporation should be treated as favorably as homeowners. However, we do not believe that they should be entitled to more favorable treatment. In this regard, it is appropriate to note that the proposed change would provide tenant-stockholders of cooperatives with additional advantages over homeowners that are difficult to justify. As discussed above, cooperatives have used earnings allocable to noncooperative activities to provide tax-free benefits to its tenant-stockholders in the form of reduced maintainance charges. By comparison, an individual homeowner who engages in investment activities or who operates a trade or business in corporate form is treated as having received a dividend when the corporation pays a personal expense. If these activities are conducted outside of a corporation, the taxpayer would not be able to use the special tax benefits that the corporation receives.

Similarly, a condominium management association is not able to use income derived from transactions with outsiders to the same extent as cooperative housing corporations. Although section 528 of the Code allows condominium management associations to receive 40 percent of their gross income from outsiders, this sum is likely to be less than the amounts that cooperative housing corporations may receive since condominium management associations generally do not receive, as gross income, amounts attributable to the real estate taxes and mortgage interest on the residences. Moreover, condominium management associations are denied certain tax benefits that corporations presently receive.

To summarize, the current tax treatment of cooperative housing corporations is at least as favorable as that received by competing forms of home ownership. Improvement in the relative position of cooperative housing corporations is unwarranted. For this reason, the Treasury Department opposes the proposed change to the 80 percent requirement.

The second provision of S. 1764 concerns the characterization of "original sellers" as tenant-stockholders. As originally enacted, section 216 provided that a tenant-stockholder was required to be an individual. Income derived from stockholders who were not individuals would not count towards satisfying the 80 percent requirement. Unforeseen events, such as the acquisition by foreclosure of stock by a bank or a sponsor of the cooperative, could cause the remaining tenant-stockholders to lose deductions attributable to their ownership of their cooperative stock.

To avoid certain of these problems, Congress has allowed lending institutions and "original sellers" who acquire stock by foreclosure to be treated as tenant-stockholders for three years. In addition, an original seller may hold stock acquired from the corporation for a three year period. S. 1764 would eliminate the three year period in determining whether the original seller qualifies as a tenant-stockholder.

We recognize that the restrictive definition of the term tenant-stockholder may create serious problems. For example, the death of a tenant-stockholder would result in the estate becoming a stockholder of the cooperative for a period of time. Since income derived from the estate would not qualify for the 80 percent test, it is possible that all tenant-stockholders could lose their interest and real estate tax deductions. Again, we would be willing to work with this Committee to establish rules for allowing temporary ownership of stock by such entities as estates to avoid this problem. In addition, we would not object to a proposal to extend the three year temporary period where the proprietary lease is subject to the right of an existing tenant to remain in the residence in question.

However, we oppose the broader proposal of S. 1764 to allow the "original seller" to hold stock in a cooperative housing corporation for an unlimited period. We believe that the traditional notion of a housing cooperative as a group of individuals acting together should not be abandoned. In addition, this proposal would enable a corporation to realize the most significant benefits of filing consolidated tax returns without subjecting itself to the existing consolidated tax return regulations. We do not believe that this is appropriate.

I would be pleased to answer any questions you may have.

Senator PACKWOOD. We will next hear from Don deKieffer, the General Counsel for the Office of the United States Special Trade Representative.

I might indicate again that all statements of witnesses will be placed in the record in full, and we would appreciate it if you would abbreviate your testimony and stay within the time limits that we have.

Go right ahead.

[The prepared statement follows:]

PREPARED STATEMENT, DONALD DEKIEFFER, GENERAL COUNSEL, OFFICE OF U.S. TRADE REPRESENTATIVE

My name is Donald deKieffer, and I am the General Counsel of the Office of the United States Trade Representative. I am pleased to appear before your subcommittee today representing Ambassador Brock and U.S.T.R. As members of the Senate Finance Committee are aware, the Office of the United States Trade Representative is the agency with lead responsiblity for passage of S. 708, Senator Chafee's amendments to the Foreign Corrupt Practices Act. We believe that it is imperative that reform legislation be enacted and passed as quickly as possible to eliminate the export disincentive aspects of this well-intended law. For these reasons, we are most happy that this subcommittee has scheduled today's hearing on the tax provision of S. 708, now before this subcommittee as separate legislation, S. 1749.

The changes proposed in S. 1749 are minor in comparison to the FCPA reforms embodied in S. 708. However, the conforming tax changes in this legislation are of major importance to U.S. companies operation and competing in foreign countries. The discrepancies between the defintions of an illegal payment found in the U.S. Tax Code and in the Foreign Corrupt Practices Act are no less serious a disincentive to entering export markets than are some of the more ambiguous provisions of the FCPA itself.

Under the present Section 162(c) of the Internal Revenue Code, no deduction is permissible for any payment to a foreign official by a U.S. taxpayer that would be illegal if U.S. law applied to such payment. This adverse tax consequence occurs regardless of whether U.S. law actually applies to the payment or whether the payment is legal where made.

Further, Section 1065 of the Tax Reform Act of 1976 provides that any Section 162(c) payment by a foreign corporation controlled by a U.S. taxpayer be included as Subpart F income and not be deductible in calculating Earnings and Profits under Section 952. In the case of a Domestic International Sales Corporation (or a "DISC") of a U.S. taxpayer, Section 162 payments are treated as a "deemed distribution" to the U.S. shareholder.

Briefly stated, the Tax Code provisions do not permit any deduction for any payment to an official or employee of any government, if the payment is illegal under U.S. law. Payment location is immaterial. Legality of non-U.S. country law is immaterial.

Also, illegal payments reduce the tax deferral benefits of the Domestic International Sales Corporation ("DISC") provisions of the Code.

The problem for U.S. companies arises when we refer to the Foreign Corrupt Practices Act for a definition of what is legal or illegal behavior. This Administration, like the Carter Administration, has argued that such a definition is not clearly written in the FCPA, and this ambiguity has had a chilling effect on American business people competing overseas. Clearly, enactment of the language recommended in S. 708 will go a long way toward alleviating much of this ambiguity by listing specific types of payments and practices which are not intended to be covered by the FCPA prohibition.

Nonetheless, even under the present Act, "grease" or facilitating payments, of which the recipients are lower level bureaucrats who perform ministerial or clerical duties, are not prohibited. In writing the FCPA in 1977, Congress consciously set aside these types of payments as legal under U.S. law on the grounds that they constituted a necessary practice in many areas of the world. The classis example is that of the foreign dock steward who refuses to unload a shipment of perishable goods unless he has received a "tip" or "gift".

Unfortunately, the Tax Code definition refers only to U.S. law, which includes several statutes that prohibit the giving of anything to any public official with intent to influence. Consequently, the "grease" payment which is acceptable under the present FCPA, is unacceptable according to the U.S. Tax Code.

The problem will become even more onerous with the passage of the reforms in S. 708. As currently written, Section 5 of the Senate Banking Committee-approved bill, the bribery prohibitions of the Foreign Corrupt Practices Act would not apply to:

"(1) any facilitating or expediting payment to a foreign official the purpose of which is to expedite or to secure the performance of a routine governmental action by a foreign official, as distinguished from governmental action in which the exercise of judgment by the foreign official is a significant factor;

(2) any payment, gift, offer, or promise of anything of value to a foreign official which is lawful under the laws and regulations of the foreign official's country;

(3) any payment, gift, offer, or promise of anything of value which constitutes a courtesy, a token of regard or esteem, or in return for hospitality;

(4) any expenditures, including travel and lodging expenses, associated with the selling or purchasing of goods or services or with the demonstration or explanation of products; or

(5) any ordinary expenditures, including travel and lodging expenses, associated with the performance of a contract with a foreign government or agency thereof."

With the clear delineation of specific acceptable foreign payments in a newly amended FCPA, a conforming tax law change will become a necessity. This is especially true of the proposed provision stating that if the behavior is legal in the country where it takes place, it does not constitute a violation of the FCPA.

At present the FCPA and the U.S. Tax Code do not correspond in their definitions of illegal payments. Arguably, the Tax Code should have been amended when the FCPA was signed into law. It was not. A problem exists today for U.S. companies. A much bigger problem will exist once S. 708 becomes law.

What is the problem such a discrepancy creates? Contrary to the stated purpose of the Tax Code's business deduction allowances, the problem is not one of tax benefits or liability. The tax impact on facililtating payments, gifts, or marketing expenses in overseas operations is minimal. Deductions for such corporate outlays are not what is at stake.

Instead, the problem arises from a potential failure to report such expenses accurately, as well as the potential loss of DISC benefits. For example, filing of a fraudulent tax return can incur a civil penalty equal to 50 percent of the tax amount. A willful failure to keep books and records or to supply required information at the time it's required could lead to a penalty of up to $10,000 in fines and/or one year in prison. And any willful attempt to evade or defeat tax liability is a $10,000 fine and/or up to 5 years in prison.

As for the reduction or elimination of DISC benefits, such an adverse consequence could run into the millions of dollars for individual companies.

For these graphic reasons, it is imperative that we have a tax code and a statutory prohibition against bribery of foreign officials which are understandable, and compatible. U.S. businesses, especially smaller and medium-size companies, must not be subjected to conflicting definitions of legal and acceptable behavior.

Section 9 of S. 708 and S. 1749 would amend I.R.C. Section 162(c) to provide that nondeductibility (and, therefore, adverse Subpart F and DISC treatment) would occur only if a payment by a U.S. taxpayer, controlled foreign corporation, or DISC violates the FCPA. Thus, U.S. law would no longer be applied on a hypothetical basis under Section 162(c) but, rather, the actual U.S. statutory prohibition under the FCPA (and no other) would be incorporated within the terms of the tax penalty provisions.

Enactment of these changes would create a single comprehensible definition of prohibited payments for both the Tax Code and the Foreign Corrupt Practices Act. Such consistency will improve both laws, and provide much needed certainty to taxpayers and exporters.

It is my hope that this subcommittee and the Senate Finance Committee will act in unison with the Senate Banking Committee and approve this tax provision swiftly and recommend to the Senate passage of S. 1749, as included in S. 708.

STATEMENT OF DONALD DE KEIFFER, GENERAL COUNSEL, OFFICE OF THE U.S. SPECIAL TRADE REPRESENTATIVE

Mr. deKeiffer. Thank you very much, Mr. Chairman. I am very pleased to appear before your subcommittee today representing Ambassador Brock and the U.S. Trade Representative.

As members of the committee are aware, USTR is the agency with lead responsibility for the passage of S. 708, Senator Chafee's amendments to the Foreign Corrupt Practices Act. We believe that it is absolutely imperative that reform legislation be enacted and passed as quickly as possible to eliminate the export disincentive aspects of this law. For these reasons, we are very happy that this subcommittee has scheduled today's hearing on the tax provision of S. 708 before this committee as separate legislation in S. 1749.

The changes proposed in S. 1749 are minor in comparison to the FCPA reforms embodied in S. 708. However, the conforming tax changes in this legislation are of major importance to the U.S. companies operating and competing in foreign countries.

Under the present section 162(c) of the Internal Revenue Code, no deduction is permissible for any payment to a foreign official by a U.S. taxpayer that would be illegal if U.S. law applied to such a payment. This adverse tax consequence occurs regardless of whether U.S. law actually applies to the payment or whether the payment is legal where made. We have stated the Tax Code provisions do not permit any deduction for any payment to an official or an employee of any government if the payment is illegal under current U.S. law. The payment location is immaterial and legality under foreign law is immaterial. Also, illegal payment reduce the tax deferral benefits of the Domestic International Sales Corporation in the provisions of the code.

The problem for U.S. companies arises when we refer to the Foreign Corrupt Practices Act for a definition of what is legal or illegal. This administration, like the prior administration, has argued that such a definition is not clearly written into the FCPA, and this ambiguity has had a chilling effect on American business people competing overseas. Clearly, enactment of the language recommended in S. 708 would go a long way toward alleviating much of this ambiguity by listing specific types of payments and practices which are not intended to be covered by the FCPA prohibition.

Nevertheless, even under the present act, facilitating payments of which the recipients are lower level bureaucrats who perform ministerial or clerical duties are not prohibited. In writing the FCPA in 1977, the Congress consciously set aside these types of payments as legal under U.S. law on the grounds that they constituted a necessary practice in many areas of the world. The classic example is that of a foreign dock steward who refuses to unload a shipment of perishable goods unless he receives a tip.

Unfortunately, the Tax Code definition refers only to U.S. law, which includes several statutes that prohibit the giving of anything to any public official with intent to influence. Consequently, the grease payments, if you will, which are acceptable under the present FCPA, is unacceptable according to the U.S. Tax Code.

Thus, at present, the FCPA and the U.S. Tax Code do not correspond in their definitions of illegal payments. Arguably, the Tax Code could be amended, should have been amended when the FCPA was signed into law in the first place. It was not. The problem exists today for U.S. companies, and a much bigger problem will exist once S. 708 becomes law.

What is the problem this discrepancy creates? Contrary to the stated purpose of the Tax Code's business deduction allowances, the problem is not one of tax benefits or tax liability. The tax impact on facilitating payments or gifts or marketing expenses in overseas operations is minimal. Deductions for such corporate outlays are not what is at stake. Instead, the problem arises from a potential failure to report such expenses accurately, as well as the potential loss of DISC benefits. Such adverse consequences could run into millions of dollars for individual companies and involve severe criminal penalties.

For these reasons we believe that it is imperative that we have a tax code and a statutory prohibition against bribery of foreign officials, which is understandable and compatible. U.S. businesses, particularly smaller and midsized companies, must not be subjected to the conflicting definitions of legal and acceptable behavior.

Section 9 of S. 708 and S. 1749 would amend IRC section 162(c) to provide that nondeductibility and, therefore, adverse subpart F and DISC treatment would occur only if the payments made by a U.S. taxpayer, controlled foreign corporation or DISC violates the FCPA. Thus, the U.S. law would no longer be applied on a hypothetical basis under section 162(c) but, rather, the actual U.S. statutory prohibition under the Foreign Corrupt Practices Act and no other would be incorporated within the terms of the tax penalty provisions.

Enactment of these changes would create a single comprehensible definition of prohibited practices for both the Tax Code and the FCPA. Such consistency, we believe, would provide a needed certainty to taxpayers and to exporters.

It is my hope that this subcommittee and the Senate Finance Committee will act in unison with the Senate Banking Committee and approve this tax provision swiftly and recommend to the Senate the passage of S. 1749 as included in S. 708.

Thank you very much, Mr. Chairman.

Senator PACKWOOD. Senator Byrd.

Senator BYRD. You refer twice in your statement to S. 708. You say that the problem will become more onerous with the passage of the reforms in S. 708. What is the status of S. 708?

Senator PACKWOOD. Well, I can tell you. It was reported out of the Banking Committee with all but two favorable votes—11 to 4. Excuse me. And it is now waiting to come to the floor.

Senator BYRD. Well how will the situation to which you refer, Mr. deKeiffer, become more onerous with the passage of the reforms in S. 708?

Mr. DEKEIFFER. Well, Senator Byrd, the provisions of the Foreign Corrupt Practices Act—the provisions of S. 708 are designed to clarify many of the problems that exist under the current law. If S. 708 goes through as it currently is, without the tax provisions that are incorporated in S. 1749, we believe that additional uncertainty would be placed upon taxpayers and exporters as to exactly what is legal and what is illegal.

S. 708 has been sold on the basis that it is a clarifying bill. We believe that more questions would be raised than answered if——

Senator BYRD. Do you feel it is not a clarifying bill?

Mr. DEKEIFFER. We believe that it is a clarifying bill, but if this particular provision is not enacted then it will create even more doubt as to what the law is, because there will be a conflict in the law. People still will not know exactly what is legal and what is illegal. We believe it is an absolutely essential element of S. 708.

Senator BYRD. Thank you.

Senator PACKWOOD. Senator Chafee?

Senator CHAFEE. Nothing, thank you.

Senator PACKWOOD. Senator Symms.

Senator SYMMS. No questions, Mr. Chairman. Thank you.

Senator PACKWOOD. Thank you very much.

We will now move on to a panel composed of Senator Curtis, John S. Noland, Jack Battaglia, and Richard Roberts. We are delighted to have Senator Curtis back in force. He served on this committee for years with distinction and as its ranking Republican member for many years.

Senator CURTIS. Mr. Chairman, may I state that we are delighted to appear and be listed as part of a panel of the American Bar Association. But it happens that Mr. Nolan is making the official statement for the bar association, and the rest of us are speaking in our own right.

Senator SYMMS. Mr. Chairman, could I make a brief comment at this point?

Senator PACKWOOD. Yes, sir.

STATEMENT OF HON. STEVEN D. SYMMS, A U.S. SENATOR FROM THE STATE OF IDAHO

Senator SYMMS. I thank you very much, Mr. Chairman, and I want to thank you and the chairman of our committee, Senator Dole, for scheduling this hearing.

I introduced S. 1594 for two basic reasons. First, I believe it is a just bill, and it will correct a provision in our tax law which often results in an injustice and in unequal treatment of taxpayers.

Second, I have introduced this bill because I believe the enactment of this proposal would be in the best interests of the Government. The present statute is not conducive to the best administration of our tax laws.

The present law provides for a civil broad penalty of 50 percent on the entire deficiency shown on the tax return. This means that the amount of the penalty is not determined by the magnitude of the fraud, but in many cases the amount of the penalty is determined by items in the return which are in no way tainted with fraud.

Let me make an illustration. Let us take the case of two Government accountants, and we assume that they work side-by-side in the same office. The third party asks these two accountants to do an accounting job when they are off duty, and he pays each of them in cash. Let us further assume they both make the mistake of deciding not to report the cash income. The one accountant has no other items to be adjusted in his return, but the second accountant had honestly thought a certain transaction was attached to the gift. But the IRS held it to be ordinary income, and this resulted in a deficiency of $1,000.

Let us assume the failure to report this cash income on the part of these two men came to light, and they were called upon to pay a civil fraud penalty, and that it resulted in a $300 deficiency for each of them. How would they be treated?

Under the present law the civil fraud penalty is 50 percent of the entire deficiency. One accountant will have a civil fraud imposed upon him of $150; the other one, because of a circumstance in his return unrelated to fraud, will pay a penalty of $650, or more than four times the penalty assessed against his coworker. One penalty was too small, the other too large. This manifestly is unfair and should be corrected.

The present law creates a difficult problem for the Government, also. If the pending measure were the law to be applied in this situation, each of the individuals would be assessed a civil fraud penalty of $300. And my bill increases the penalty on fraud-tainted items. I hope this measure can be advanced by the Committee on Finance and enacted into law.

I would note, Mr. Chairman, that you heard Treasury's testimony. I think that I don't object to having Treasury carefully study this, and I look forward to hearing from our witnesses this morning: Senator Curtis and his two distinguished colleagues from the bar. I look forward to their testimony, and then we will see that we make that available to Treasury and, hopefully, they will see the wisdom of what I think we are about to hear here.

So I will yield back my time. I again express my thanks for your bringing this measure forward before the committee.

Thank you, Senator.

Once more, let me explain to the witnesses why we have these hearings and why I would prefer that you put your statement in the record and tell us orally the main points.

This tax subcommittee has hearings on literally dozens of bills, most of which are inequities in the Tax Code in the eyes of the proponents. They may not be in the eyes of the opponents, but they are in the eyes of the proponents.

We have these hearings so that we can get a complete record on it, get Treasury's positions, and also not be subject to the charge that we are considering bills and markups that have never had a hearing nor where the opponents have had a chance to make their case. Most of the topics are not complex, and we understand them; so it is much more helpful to us to have you very forceably and orally state what your positions are, knowing full well that we will have a chance to read in detail, and the staff will read in detail, the statements that will be in the record.

Senator Curtis, do you want to go first?

Senator CURTIS. I would yield to Mr. Nolan.

Senator PACKWOOD. All right.

Mr. Nolan, go right ahead.

STATEMENT OF JOHN S. NOLAN, CHAIRMAN OF THE AMERICAN BAR ASSOCIATION SECTION ON TAXATION, REPRESENTING THE AMERICAN BAR ASSOCIATION, WASHINGTON, D.C.

Mr. NOLAN. Thank you, Mr. Chairman. I will summarize my written statement.

The position of the American Bar Association is that the civil fraud penalty should be based upon the deficiency in tax attributable to items as to which there was fraud rather than upon the entire tax deficiency as under existing law. Accordingly, we support S. 1594, as proposed by Senator Symms, providing that taxpayers should be given an opportunity to prove the absence of fraud as to particular items. To the extent the taxpayer is able to carry this burden of proof, the civil fraud penalty would apply only to the fraud-tainted items.

S. 1594 would also change the civil fraud penalty from 50 percent of the total deficiency to 100 percent of the deficiency attributable to items as to which the taxpayer has not carried the burden of proving the absence of fraud. Now this latter feature involves new considerations which the American Bar Association has not previously addressed before the Congress and which I will discuss today.

First of all, S. 1594 would not change the fact that a civil fraud penalty would become applicable once the Government has proved that any part of an underpayment of tax is due to fraud. It would merely permit the taxpayer, subject to the burden of proof, to establish the absence of fraud with respect to particular items giving rise to the underpayment or deficiency in tax. The civil fraud penalty would be based on the balance of the deficiency, as to which the taxpayer failed to prove that there was no fraud. This more refined application of the civil fraud penalty would be fairer; it would tend to eliminate unduly harsh and capricious effects of the existing penalty; and it would facilitate the settlement of cases without litigation.

The current civil fraud penalty can work unfairly because it can punish conduct which is plainly not wrongful. Consider a taxpayer with competent professional advice who takes a position on his tax return that subsequently turns out to be incorrect. Ordinarily, no penalty would or should attach to that conduct. If, however, there is also an unrelated fraud-tainted item on the taxpayer's return, the current law will punish the taxpayer for the nonfraudulent mistake of his professional adviser as well as for the fraud.

The current civil fraud penalty violates the general principle that punishment should be commensurate with the offense. This provision as it now exists can result in penalties that are disproportionately large compared to the amount of the fraud-tainted items. A small businessman, for example, can and should incur a civil fraud penalty for fraudulently disguising a nondeductible political contribution as a deductible business expense, but the penalty should not become many times larger because of a completely unrelated adjustment capitalizing some of his repair costs or reducing his bad debt deduction, when there was no fraud of any kind involved in the repair cost or bad debt deduction items.

It is generally accepted that the courts and the Internal Revenue Service, recognizing the capriciousness of the current civil fraud penalty, often refuse to apply the 50-percent penalty where it would be grossly disproportionate to the extent of the wrongdoing or would be unduly burdensome.

This exercise of discretion, however, introduces inconsistency into the application of the penalty and forces a choice between the equally unsatisfactory alternatives of a penalty that is either unduly harsh or a failure to penalize culpable behavior. For much the same reasons the existing penalty provision lends itself to misuse as a lever to force possibly unwarranted concessions by the taxpayer in order to avoid overly punitive effects from imposition of the fraud penalty.

The Internal Revenue Service and the Department of Justice have asserted that S. 1594 would diminish the in terrorem effect of the civil fraud penalty and would thereby reduce voluntary compliance with the tax laws. We do not agree. Of primary importance, it is the risk of criminal prosecution for tax fraud that supports voluntary compliance, and S. 1594 would not lessen the risk of criminal penalties to any extent. Furthermore, a taxpayer will never know in advance that the Internal Revenue Service will not assert the fraud penalty with respect to the whole deficiency. In making choices as to potentially fraudulent conduct, he is not likely to be weighing the fact that if the tax deficiency is enlarged on account of items as to which there is no fraud and as to which he can prove there was no fraud, even though by hypothesis there is fraud on his part to some extent, his penalty would be reduced.

We think further that S. 1594 will actually facilitate the administration of the tax laws. During an audit or an administrative appeal of a case involving potential deficiencies in respect to both nonfraud and fraud-tained items, the ability of the Internal Revenue Service to impose the fraud penalty selectively will encourage settlements by taxpayers. Furthermore, even where litigation occurs, it may facilitate stipulations by the parties as to many issues as to which they can agree there was no fraud by the taxpayer.

There is some legitimate concern that S. 1594 would result in lengthier and more complex tax trials. This is due to the fact that where a taxpayer introduces evidence showing the absence of fraud with respect to particular items, the Internal Revenue Service will be required to produce evidence to establish fraud with respect to each such separate item. Under existing law the issue of fraud need be litigated with respect to a single deficiency item, any single deficiency item, in order to impose the penalty on the entire deficiency.

But expedience should not be given a higher priority than equity and consistency in the administration of our tax system. Although tax fraud is a gross violation of civic duty and responsibility and should be punished, the punishment must always bear a reasonable relationship to the extent of the violation. If criminal conduct is involved, severe criminal penalties may be imposed. The civil fraud penalty, however, is civil punishment, and as such should be applied fairly and uniformly.

I might just add in conclusion that where the evidence does show a clearcut overall pattern of fraud, the courts can certainly be expected to offer no encouragement to allegations that specific items are exempt from the taint. In other words, where the taxpayer's fraud is pervasive, the courts are likely to impose a very heavy burden of proof on the taxpayer who seeks to show that some item leading to the tax deficiency involved no fraud.

In summation, we think this is a very fine provision which will increase the equity of the system and will encourage settlements and should be enacted.

Thank you.

Senator PACKWOOD. Thank you very much, Mr. Nolan.

Senator Curtis.

STATEMENT OF HON. CARL T. CURTIS, NELSON & HARDING, WASHINGTON, D.C.

Senator CURTIS. Mr. Chairman, I am delighted to be here. With me on this panel is Mr. Jack Battaglia of Rochester, N.Y., and Mr. Richard M. Roberts of Washington.

I will have considerable material to be printed in the record, so I will be very brief, then I would like to have these men heard from briefly, also.

It is very basic to our tax law that taxpayers should have equal treatment. As the statute now stands, two individuals, each having failed to report outside income that they received in cash in an amount which resulted in a $500 deficiency for each, and if one of these individuals had in his return an unintentional mathematical error which resulted in a $1,000 deficiency for him, the latter individual would face a civil fraud penalty of $750 while the first-mentioned individual would face a civil fraud penalty of only $250. This is manifestly unfair. Under S. 1594 each would receive a penalty of $500.

This could also happen: An individual could be guilty of fraudulently omitting an item, but if he had some accidental errors in his return in favor of the IRS there would be no penalty applied, because the accidental errors in favor of the IRS would offset it and there would be no deficiency. And that shows the other extreme of the problem.

Our tax system is based on voluntary reporting of income by the taxpayers. If our laws are such that the IRS is able to treat all taxpayers with ordinary simple rules of common justice, the IRS will maintain the confidence and cooperation of all the taxpayers. This in return will result in fewer problems, less expense for all, and fuller reporting of income.

Mr. Chairman, I offer a statement of Mr. Terry Phillip Seigel, who used to be employed in this Senate. Later on he was assistant U.S. attorney here in the District of Columbia. He was chairman of the Subcommittee on Criminal Penalties with the American Bar Association. And here is what he says:

> In my judgment the present law works against the Government's own interest in criminal tax cases. When I prosecuted criminal tax fraud cases as an Assistant United States Attorney, I can recall several instances where defendants, upon learning that the civil fraud penalty would subsequently be applied to the entire civil deficiency for an indictment year, put the Government to the time and expense and uncertainty of a criminal trial rather than plead guilty.
>
> I am persuaded that, had S. 1594 been the law when I prosecuted criminal tax cases, these defendants would have plead guilty.

Senator BYRD. Mr. Curtis, who wrote that letter?

Senator CURTIS. That is a statement I will offer for the record. Mr. Terry Phillip Segal.

Senator BYRD. And he was a former U.S. attorney here in the District of Columbia?

Senator CURTIS. Assistant U.S. attorney.

Senator BYRD. Thank you.

[The statement follows:]

STATEMENT OF
TERRY PHILIP SEGAL
IN SUPPORT OF S.1594

My name is TERRY PHILIP SEGAL, and I presently practice law in Boston, Massachusetts. In my law practice, I specialize in the representation of people who are being investigated by the Internal Revenue Service for possible criminal violations of the tax laws.

Let me briefly summarize my educational and vocational experience. In 1964, I graduated from Amherst College, Amherst, Ma. with a B.A. degree. In 1967, I received an LL.B. from Yale Law School. After graduating from law school, I spent 18 months as legislative counsel to U.S. Senator Philip Hart of Michigan. From December, 1968 to July, 1970, I was an Assistant United States Attorney for the District of Columbia. From May, 1971 to August, 1973, I was an Assistant United States Attorney for the District of Massachusetts. In this capacity, I was responsible for the prosecution of Federal criminal income tax cases in Massachusetts. Since leaving the Government, I have been in private practice - specializing in the defense of Federal white collar criminal cases. For several years, I was Chairman of the Sub-Committee on Criminal Penalties of the American Bar Association Tax Section's Committee on Civil and Criminal Tax Penalties. Additionally, I have written approximately ten articles for various legal publications on the subject of income tax evasion, and have taught for six years at Boston College Law School.

Based upon my experience as a prosecutor and defense counsel, I strongly support S.1594. Under present law, the 50 percent fraud penalty attaches to the taxpayer's total deficiency. S.1594 would correct this inequity by changing the fraud penalty to the deficiency resulting from fraud.

In my judgment, present law works against the Government's own interest in criminal tax cases. When I prosecuted criminal tax fraud cases as an Assistant United States Attorney, I can recall several instances where defendants upon learning that the civil fraud penalty would subsequently be applied to the entire civil deficiency for an indictment year, put the Government to the time and expense and uncertainty of a criminal trial rather than plead guilty. I am persuaded that had S.1594 been law when I prosecuted criminal tax cases, these defendants would have pleaded guilty. Ironically, my recollection is that one of the defendants who decided to plead not guilty after learning that the civil fraud penalty would be attached to the entire deficiency was acquitted.

As a defense counsel, my experience is that because of present law, I have recommended to several clients that they go to trial rather than plead guilty. Had S.1594 been the law, I am sure my recommendation would have been different.

Terry Philip Segal

Terry Philip Segal

Senator CURTIS. Here is a letter from Mr. J. Richard Johnston of Oakland, Calif. I will offer the entire original letter. He was special attorney from 1946 to 1951 in the Penal Division of the Office of Chief Counsel of the, then, Bureau of Internal Revenue. And he says: "The inequity of the present fraud penalty is so obvious as to require no explanation or argument. It simply bears no relation to the extent of the fraud."

[The letter follows:]

JOHNSTON & KLEIN,
ATTORNEYS AT LAW,
Oakland, Calif., October 27, 1981.

Subject: Revision of Internal Revenue Code (Pertaining to Fraud Penalty).

Senator ROBERT J. DOLE,
U.S. Senate, Washington, D.C.

DEAR SENATOR DOLE: I am told that Senator Symms' bill, S. 1594, has been set for hearing before a subcommittee of the Senate Committee on Finance on November 6. I respectfully submit this statement in support of the bill.

I have been involved in federal tax work for 35 years; from 1946 to 1951 as a special attorney in the Penal Division of the Office of Chief Counsel of the (then) Bureau of Internal Revenue, and since that time in private practice as a tax specialist in Oakland, California. My work in the Penal Division consisted entirely in reviewing cases where criminal prosecution had been recommended, and a major part of my practice since leaving the government has consisted of representing taxpayers under investigation or indictment for tax fraud.

The inequity of the present fraud penalty is so obvious as to require no explanation or argument; it simply bears no relationship to the extent of the fraud. Senator Symms' bill would remedy this inequity by basing the penalty on the amount of underpayment due to fraud, and doubling the rate of the penalty, from 50 percent to 100 percent.

Amending section 6653(b) of the Internal Revenue Code in this manner would, in my opinion, rationalize that portion of the law and work a significant improvement in Internal Revenue Code.

Sincerely yours,

J. RICHARD JOHNSTON.

Senator CURTIS. I have a statement here by Mr. C. James Judson of Seattle, Wash. And I will offer that in full.

He points out how erroneous the present system is.

[The letter follows:]

DAVIS, WRIGHT, TODD, REESE & JONES,
Seattle, Wash., October 22, 1981.

Senator STEVEN D. SYMMS,
Room 125, Senate Office Building, Washington, D.C.

DEAR SENATOR SYMMS: I write in support of S. 1594. I am a tax lawyer in Seattle, Washington. I have twelve years' experience in dealing with both civil and criminal tax fraud matters on behalf of taxpayers. These dealings have been both administrative before various levels of the Internal Revenue Service as well as in the courts. I have long been concerned about the civil tax fraud penalty provided by Internal Revenue Code Section 6653(b)(1), the so-called 50 percent fraud penalty. As you know, the penalty applies to the full amount of tax understatement which is determined on audit, regardless of whether the understatement arises from the claimed fraudulent action or from inadvertence or ignorance. The punishment simply does not fit the proscribed action. For that reason it should be modified as provided in your S. 1594.

I have had taxpayers who have both been substantially benefited and substantially damaged by the current mechanism of IRS Section 6653(b)(1). I have had clients who have been accused of civil tax fraud by the Internal Revenue Service in situations where the claimed fraudulent action constituted five percent or less of agreed upon understatements. The fraud penalty there obviously is a very heavy weight for those taxpayers to carry.

On the other hand, I have represented taxpayers who have taken tax positions which the IRS has asserted are fraudulent, but where those tax positions have been substantially offset by accidental errors in favor of the Internal Revenue Service.

The net amount found due by the taxpayers has been nominal. Their alleged substantial fraudulent activity has given rise to a very small actual penalty.

In neither circumstance does the penalty fit the proscribed activity. It is my strong suggestion that S. 1594 be enacted into law by the 97th Congress.

Very truly yours,

C. JAMES JUDSON.

Senator CURTIS. And, likewise, a letter to the chairman of the subcommittee, Senator Packwood, from Charles M. Louck of St. Louis, who also for years represented the Government side of this.

He points out, among other things, how a corporation owned by many shareholders can be punished unjustly because 10 people may be responsible for the tax return and one of them does something he shouldn't. And yet that corporation has many items in dispute, and an assessment comes in for a tremendous amount, which is a regular happening.

The shareholders are all punished for the happenstance of the return.

[The letter follows:]

CHARLES M. LOCK,
ATTORNEY AT LAW,
St. Louis, Mo., November 2, 1981.

Senator BOB PACKWOOD,
Subcommittee on Taxation and Debt Management, Committee on Finance, Washington, D.C.

DEAR SENATOR PACKWOOD: This letter is in regard to Senator Symms' S. Bill 1594. I understand your Subcommittee will hold hearings on this tax bill on November 6, 1981. Please give this bill your favorable consideration.

From 1967 to 1978 I was a trial attorney with Chief Counsel's Office, Internal Revenue Service, in St. Louis, Missouri. Since March, 1978 I have been a sole practitioner, specializing in civil and criminal tax law. I also teach part time in the Masters Program at Washington University.

I believe the examples set forth in the Congressional Record dated October 5, 1981, adequately explains the inequity of Code § 6653(b) as it pertains to individuals. Even though the public and lawmakers seem reluctant to grant tax relief to corporations we must remember shareholders are the true benefactors of a correction of an injustice in the tax law.

In this day of divided responsibility it is extremely harsh to punish all shareholders for the impropriety of perhaps one individual who causes a false return to be filed. For instance, there may be ten individuals who have the responsibility for gathering the information necessary for filing a return. Nine of the individuals may do their best to insure an accurate return is filed. One of the individuals may be the cause of an item either not being reported or falsely deducted. Assume there is an honest dispute which results in a deficiency of $100,000. Assume further that the fraudulent item casued by the misguided employee accounts for a deficiency of only $1,000. Instead of the shareholders being the victim of a $500.00 penalty, they end up under the present law of being punished with a $50,500 penalty assessment. This could jeopardize the very existence of the business. Surely justice demands that shareholders be given protection under such circumstances.

A vote for approval of this Bill will be truly appreciated.

Sincerely,

CHARLES M. LOCK.

Senator CURTIS. Mr. Chairman, I have these original statements here. I will take no more time.

Senator PACKWOOD. All of those statements will be in the record in full.

Mr. Roberts.

STATEMENT OF RICHARD M. ROBERTS, HAMEL, PARK, McCABE & SAUNDERS, WASHINGTON, D.C.

Mr. ROBERTS. Senator, I endorse what Senator Curtis has said. I feel that the amendment that was spoken of earlier to the Internal Revenue Code—the proposed amendment—that would conform the Revenue Code to a Corrupt Practices Act is a good starting point, and the illustration that Senator Curtis just gave of a corporation.

In the overseas payment cases, of which there have been many fairly recently, the payments in relation to the overall liability of the taxpayer, the corporation, have been generally very small. You have many civil adjustments in most corporate tax audits by the Revenue Service.

If you take the payments that were made that violated the Internal Revenue Law and now the Corrupt Practices Act and apply the fraud penalty to those, and then to the rest of the deficiency, you have a tremendous deficiency imposed because of the 50-percent fraud penalty being applicable to the whole deficiency. I think it only equitable that it only be applicable to the fraud items.

I do have some problem with the provision that puts the burden on the taxpayer to prove his lack of fraud as to other items. It seems to me that where the Government has the burden of proving fraud as to an item, if it says other items are fraudulent then it should also have the burden as to those items. It has been able, apparently, to carry its burden as to the item that it has identified as a fraud item, and I feel that any item that it wants the 50-percent or now 100-percent fraud penalty, if the 100 percent passes here, it should identify and say that there was fraud as to that item and have to carry the burden.

Another thing that may be worth stating in passing is what is the burden going to be on the taxpayer? The Revenue Code provides that in the Tax Court the commissioner has the burden of proof to prove fraud. Now the courts have grafted onto the refund cases in the district courts the burden that the Government, by clear and convincing evidence, must prove fraud before the fraud penalty will be imposed.

Now what is the burden if this provision goes into the Code, of the burden being on the taxpayer to prove lack of fraud? Will it be the clear and convincing, or will it only be the preponderance of evidence? If this goes in, I do believe that the committee should add just what the burden of proof would be.

Thank you.

Senator PACKWOOD. Mr. Battaglia.

STATEMENT OF JACK M. BATTAGLIA, ROCHESTER, N.Y.

Mr. BATTAGLIA. I am a practicing tax attorney. I graduated from Syracuse University in 1962, and I obtained a masters in tax from Georgetown in 1965. I worked for the Internal Revenue Service for 3 years in the Rulings Division here in Washington, and I have been in private practice for the last 16 years, doing only tax work. The bulk of my practice is civil and criminal tax litigation.

Since 1978 I have represented 20 taxpayers in criminal tax investigation, all of which have resulted in a subsequent civil tax case involving the assessment of the civil fraud penalty.

I, too, agree that the present provisions of the civil fraud penalty are grossly inequitable in that they charge a taxpayer with a penalty for items of the deficiency that are not fraudulent. For example, if a deficiency has been assessed against a taxpayer for $5,000 and only $1,000 of it is attributable to fraud, the civil fraud penalty applies to the whole $5,000, so there is a $2,500 penalty on really an item that created $1,000 of fraudulent deficiency, or in fact 2½ times that deficiency in my example.

I find this to be very true in situations where an assessment has been made against a shareholder of a corporation, and I have two cases right now in which this is a very pertinent problem. In both these situations the taxpayers diverted corporate funds, roughly about, we will say, $50,000 of corporate funds. They also borrowed money from their corporation, which is a perfectly legitimate way of taking money out of the corporation. They borrowed approximately $100,000.

The $50,000 was truly a fraudulent transaction, and the Service correctly assessed the fraud penalty; but it not only applies to the $50,000 fraudulent transaction but also to the $100,000 technical item. By technical I mean that the borrowing of money from a corporation can be construed as either a true loan or as a constructive dividend to the taxpayer, and it is never the basis of a fraud penalty.

As a result of these situations like this, the Service, when it assesses the fraud penalty, has to assess it across the board, and it becomes very difficult to settle these cases, because where the Service feels that they can prove the fraud they won't let up. They insist upon applying the fraud penalty. And this is particularly true in cases in which they have recommended criminal prosecution, and the taxpayer has either won or lost his case. Even if he has won the case, even if they have decided ultimately not to prosecute or they have dropped the criminal investigation, they will apply the fraud penalty. And in those situations where the district council has recommended the fraud penalty, they will insist upon the fraud penalty and will litigate it, if necessary.

So as a result it becomes, I think, extremely difficult under the current posture of the law to negotiate settlements of tax cases. Under the Symms bill I feel that it would be a lot easier to negotiate settlement of these cases at a lower level, possibly with the revenue agent or in the Appeals Division, without having to litigate these cases.

I feel that the bill is fair in that it imposes on the taxpayer the burden of proving what items are not fraudulent. I think once the Service has proved that there is fraud involved, I think the bill correctly states that the burden of proof should shift to the taxpayer.

In passing, I would like to state that I disagree with the imposition of the 100-percent penalty, because we are now faced with two penalties under our tax laws; a criminal penalty and a civil penalty. I feel that the current criminal penalties are virtually ineffective. And if we are going to impose a 100-percent fraud penalty, I would suggest that we seriously consider removing the criminal fraud sanctions because of their lack of effectiveness at this time.

Thank you.

Senator PACKWOOD. Thank you very much.

Senator BYRD. I have nothing to ask at this time.

Senator PACKWOOD. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman. Just one brief question.

Mr. Nolan, did I understand you to say the same thing about the burden of proof? Or did I misunderstand you?

Mr. NOLAN. We have taken the position in our statement that it is appropriate for the taxpayer to bear the burden of proof as to items which are not fraudulent. I do think, however, that Mr. Roberts has made an important point; that is, what is the extent of that burden? Should the burden be one of preponderance of the evidence? Or should it be clear and convincing evidence? I think that is a matter as to which opinions might differ. I think that if the taxpayer has the burden of proof, it may be appropriate only to put the burden on him to come forward with enough evidence to carry the burden of persuasion, hot clear and unvincing evidence.

There is one thing I would like to say also about the 100-percent penalty, if I can take this opportunity to do so. In my statement, we recommended that this presents some real problems, raising the penalty level to 100 percent. One solution to that problem is to say that, while the penalty would be 100 percent of the fraud-tainted items, it could never exceed 50 percent of the total deficiency. It seems to me that is an appropriate limitation, consistent with existing law. If the taxpayer is able to establish the absence of fraud as to some items, the penalty will initially be either 100 percent of those items or no more than 50 percent of the total deficiency. We urge that you give consideration to that alternative.

Senator SYMMS. Thank you, Mr. Chairman.

Senator PACKWOOD. Senator Long.

Senator LONG. I want to say it is good to see my dear friend Carl Curtis back here. I recall very fondly the days Carl served with distinction on this committee. As always, he made a very fine argument, as did the other gentlemen here.

I think that you gentlemen on this panel have made an overwhelming case. While, of course, it may fall to someone to present a case to the contrary, I really don't see what case can be made for the other side of the argument. I think this case is compelling.

On the points that you made about the burden of proof, it seems to me that a mere preponderance of the evidence ought to be adequate. Do you agree with that, Mr. Nolan?

Mr. NOLAN. Yes; I do.

Senator LONG. In other words, you have no right to presume fraud, I would think. But if you require that, that the taxpayer go forward and show his good faith in claiming a deduction to which he thought he was entitled, it seems to me from that point forward the burden ought to be on the Government to present more proof than that to support their side of the case. Just because a person has a fraudulent item there is no reason to assume that everything there is fraudulent, just because one item is fraudulent. I think you have basically made the case.

What we are talking about here is punishment completely out of relation to the so-called crime committed. The idea of assessing the fraud penalty in a manner that relates to the offense makes sense.

But to assess it with relation to something that had nothing to do with the offense makes no sense. It is conceivable, as I understand the law, that the fine could be 10 or 50 times what the amount of the fraud was. Is that correct?

Mr. NOLAN. That is correct. And this is a real problem, because there are discrete items as to which fraud occurs but which are completely unrelated to other adjustments in the taxpayer's return.

Senator LONG. I have seen some other situations where you could have it that most people get away with their mischief, but those who get caught are crucified and drawn and quartered at sunrise. And that just makes no sense at all. The poor soul that does get caught just absolutely gets slaughtered. You have got a good case.

Senator PACKWOOD. I might say, Senator Long, that even the Treasury Department this morning, who usually testifies in opposition to all of these bills, on this one simply took no position at the moment. They wanted some time to study it, but I sense they were ready to come down on the side of the panel.

Senator SYMMS. Mr. Chairman, could I ask one other question about this 100-percent assessment of the portion that is fraudulent?

Wouldn't that be a good incentive for people not to try to actually commit frauds?

Mr. NOLAN. Senator, the biggest incentive not to commit fraud is that you are subject to criminal prosecution if you do so. That is what ultimately supports voluntary compliance. While it is appropriate, as your bill provides, to increase the penalty somewhat as to the fraudulent items, it seems to me that that should be limited, however, so that the fraudulent penalty is no greater than it is under present law—50 percent of the total deficiency.

Senator SYMMS. In other words, 50 percent is the highest tax rate?

Mr. NOLAN. Fifty percent of the deficiency in tax. We have proposed that that be computed at the highest tax rates to which the taxpayer is subject. We have a technical proposal in our statement that says you compute it at the highest tax rate.

Senator SYMMS. I see.

Mr. NOLAN. There is plenty of incentive not to commit fraud, and if we do not limit it overall, we create some interference with what we are trying to accomplish here, which is to facilitate the settlement of cases short of trial.

Senator SYMMS. That is your point, then?

Mr. BATTAGLIA. Absolutely. But I disagree about the effectiveness of the criminal penalties. I feel that taxpayers are motivated by greed, and the way to hit them and hit them where it hurts is in their pocketbook. They are not afraid of going to jail, they are afraid of paying more taxes and more penalties. I think the 100-percent fraud penalty would be a very effective deterrent. But I don't think it is going to be twice as much effective as a 50-percent penalty.

Senator SYMMS. Thank you very much, Mr. Chairman. Thank you, gentlemen and Senator Curtis. This is twice this week we have had you up here, Senator Curtis, and we appreciate it.

Senator CURTIS. Thank you.

Senator PACKWOOD. An excellent presentation, gentlemen.

Excuse me, Dave. Did you have any questions on this?

Senator DURENBERGER. No, Mr. Chairman.

[The prepared statements of the previous panel follow:]

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November 5, 1981

Honorable Bob Packwood
Chairman Subcommittee on
Taxation and Debt Management
Senate Committee on Finance
Room 2227 Dirksen Senate
Office Building
Washington, D.C.

Dear Senator Packwood:

As explained by Retired Senator Carl T. Curtis in his letter to Robert Lighthizer, I will be testifying along with Jack M. Battaglia and him in support of S. 1594 as it relates to imposition of the fraud penalty on the fraud item only. I am a former Deputy Assistant Attorney General in the Tax Division of the Department of Justice, a position I held for thirteen years and in which I saw many cases involving the imposition of the fraud penalty.

S. 1594 would limit the imposition of the fraud penalty to the amount of the tax deficiency proposed by the Internal Revenue Service which is due to the fraudulent act or acts of the taxpayer.

I have thought it unfair to impose this fraud penalty on the entire amount of a deficiency where only part is due to fraud. If, for example, taxpayer A has a $10,000 deficiency, $500 of which results from a fraudulent omission from income and $9,500 from an honestly held belief that a particular gift was a non-taxable gift, A will pay a $5,000 fraud penalty; if B, on the other hand, has a $3,000 deficiency, all of which results from a similar fraudulent omission, he will pay a penalty of only $1,500 under existing law.

HAMEL, PARK, MCCABE & SAUNDERS

Senator Bob Packwood
November 5, 1981
Page Two

I have seen cases where the fraudulently omitted income was little in comparison with the admittedly civil adjustments yet the fraud penalty is imposed on the full deficiency. In some instances, the Internal Revenue Service at the audit stage will settle with a taxpayer and the fraud penalty is asserted against the fraudulent item only. However, this practice is not uniform and could result in a taxpayer waiving his right to contest the civil deficiencies rather than run the risk of the imposition of the fraud penalty on the entire deficiency.

I do not believe in placing upon the taxpayer the burden of proof to prove absence of fraud with respect to other items or adjustments once the government has proved fraud with respect to any item or adjustment. It is always difficult to prove a negative and I believe absence of fraud would be difficult to show in many situations and particularly where a negligence penalty might be applicable. I believe it would be simpler to require the government to prove fraud as to each item to which it has applied a fraud penalty.

One of my partners Martin Worthy, a former Chief Counsel of the Internal Revenue Service, who is out of the city and therefore cannot testify today, has requested that I advise the Subcommittee that he agrees with the views I have expressed.

Sincerely yours,

Richard M. Roberts

RMR/mls

STATEMENT

of

CARL T. CURTIS

to the

Committee on Finance

Subcommittee on Taxation and Debt Management

Hearing on

Friday, November 6, 1981

Mr. Chairman, with me today in making up this panel are Mr. Jack M. Battaglia of 1111 First Federal Plaza, Rochester, New York, and Mr. Richard M. Roberts of the law firm of Hamel, Park, McCabe & Saunders, 888 - 16th Street, NW, Washington, DC. We are in support of S. 1594, which has been introduced by the Honorable Steven D. Symms of Idaho.

Mr. Chairman, I ask to have printed at this point in my remarks, a question and answer paper prepared by me which explains the Civil Fraud Penalty and the problems arising from it.

WHY THE CIVIL FRAUD PENALTY SHOULD BE CHANGED

This statement was prepared by Carl T. Curtis of the Nelson & Harding law firm, 1101 Connecticut Avenue, NW, Suite 800, Washington, DC 20036, in support of a request for hearings before the Committee on Finance and the Committee on Ways & Means and for presentation at the hearings of said committees.

1. Q. What is civil fraud?

   A. A finding of civil fraud is not a criminal action but it is a procedure which results in the imposition of a civil penalty. The civil fraud penalty has been described by the Supreme Court of the United States as an aid in the collection of the tax for the purpose of preventing fraud in the preparation of returns and the payment of the tax. The civil fraud penalty for the most part is measured by the tax involved.

2. Q. How does civil fraud differ from criminal fraud?

   A. An action in criminal fraud is an action to punish for a criminal offense. A criminal penalty may be imposed only after charges are brought and a guilty plea is entered or a trial is held and a conviction of a misdemeanor or a felony and is measured by the degree of the offense.

3. Q. What is the penalty for criminal fraud?

   A. The penalty for criminal fraud is a fine or imprisonment.

4. Q. What is the penalty for civil fraud?

   A. The penalty is 50% of the amount of the tax owing or, in other words, 50% of the deficiency.

5. Q. For purposes of figuring the civil fraud, what constitutes a deficiency?

   A. When a taxpayer's return is audited, any additional amounts found due constitute a deficiency.

6. Q. What kind of items could be included in the makeup of a deficiency that would have no connection with fraud and would not be tainted with fraud in any way?

A. A taxpayer may make a full disclosure of all his income. His legal counsel and his accountant may well advise him that a particular transaction ought to be claimed as a capital gain and not as ordinary income. The Internal Revenue Service may determine that the particular transaction constitutes ordinary income and thus there is a deficiency in the payment. There isn't the slightest taint of fraud and the facts were fully disclosed and the taxpayer exercised his right to ask for such a determination.

Another example of a deficiency item which may have no fraud implication at all: A taxpayer knows that he has paid out certain sizeable sums for business travel, entertainment and expenses. He claims them in his return. Upon audit, he does not have sufficient records to justify these expenses and they are disallowed. This adds materially to his tax and it is a deficiency.

Another example of a deficiency item that need not be tainted with fraud could relate to stock options. In many instances there is no tax due when the stock option is exercised, but the tax is due when the stock is eventually sold. There are situations where a tax is due when the stock option is exercised. A taxpayer may disclose every detail of the transaction in his return and exercise his lawful right and ask for a determination of no tax due. The Internal Revenue Service may find that the tax is due upon the exercise of the option and the amount of the tax involved becomes a deficiency.

An example which relates to consolidated returns is discussed in the answer to Question 10.

7. Q. Is the penalty for civil fraud applied uniformly between taxpayers?

A. No. Two taxpayers may have the same amount of income and each be found to have been fraudulent in reference to items of equal amount and these two taxpayers received vastly different penalties.

8. Q. What are some examples that show that fraud penalty is not applied uniformly.

A. Taxpayer "A" could not substantiate from records certain items of expense claimed and because he claimed a particular transaction as a capital gain instead of ordinary income he was assessed a deficiency of $2,000. It is also found that taxpayer "A" failed to include in his return some interest that he received which resulted in a $300 deficiency and the failure to include it was held to be fraudulent. The total amount of his income subject to tax including the deficiency items is $10,000. Taxpayer "A" would have a penalty of 50% of $2,000 + 300 or $1,150.

Taxpayer "B" likewise has $10,000 in income. There are no non-fraudulent items questioned in his return but he, likewise, received some interest income which he did not report. The failure to report resulted in a $300 deficiency and is determined to be fraudulent. Taxpayer "B" would be subject to a civil fraud penalty of $150.

In the above two examples both taxpayers had the same income and were charged with fraudulently omitting the same amount from their returns, yet "A" has a penalty of $1,150 and "B" has a penalty of only $150.

9. Q. Can you give some other illustrations?

A. The accountant for taxpayer M made out M's tax return and made an accounting error which was audited resulting in a deficiency of $4,000. It was also found that taxpayer M had outside earnings which he failed to report and which resulted in a $400 deficiency and this failure was held to be fraudulent. M's civil fraud penalty would be 50 percent of $4000 plus $400 or $2200. Taxpayer O has the same amount of income as taxpayer M but there were no errors in his return, but he, too, had received outside earnings which, he did not report which resulted in a $400 deficiency and this was held to be fraudulent. Taxpayer O's civil fraud penalty was $200.

Taxpayer X has a $10,000 deficiency, $500 of which results from a fraudulent omission from income and $9,500 from an honestly-held belief that a particular gift was a non-taxable gift, X will pay a $5,000 fraud penalty; if Y on the other hand, has a $3,000 deficiency, all of which results from a similar fraudulent omission, Y will pay a penalty of only $1,500 under existing law.

10. Q. Do the problems in reference to the civil fraud penalty involve corporations as well as individuals?

A. Yes. The same civil fraud penalty statute applies to all taxpayers. The problems illustrated by the foregoing examples could apply to a corporate taxpayer just as they are shown to apply to an individual taxpayer. There is an additional problem for corporations in reference to consolidated returns.

A consolidated return is a return where a parent corporation and its subsidiaries meet certain requirements and file a consolidated return for the entire corporate group. When this is done the problem relating to the civil fraud penalty may become much greater. The following two examples, which have been provided to this writer, will illustrate how the law works in reference to a consolidated return.

Example I

Corporation A is engaged in international operations. It has no subsidiaries and files a separate corporation income tax return. Officers of Corporation A paid officials of Country X $100,000 in bribes in 1977. These illegal payments were deducted by Corporation A on its 1977 return. On audit, the Service disallowed the deduction in reliance upon section 162(c)(2) of the Code, resulting in a deficiency in tax of $50,000. In addition, the Service determined that, the civil fraud penalty was applicable (§6653(b)). Therefore, Corporation A's deficiency and penalty were as follows:

Deficiency	$50,000
50% Civil Fraud Penalty	25,000
TOTAL	$75,000

Example II

An affiliated group consisting of Corporation P (common parent) and controlled subsidiary corporations C, D, E, and F has elected to file a consolidated return. Officers of Corporation C paid officials of Country X $100,000 in bribes in 1977. These illegal payments were reflected on the books of Corporation C as an expense and were deducted on the 1977 consolidated return filed by the affliliated group. On audit, the Service determined a total deficiency in tax on the part of the affililated group in the amount of $15,000,000. Of this total deficiency, $50,000 was attributable to Corporation C resulting from the disallowance of the $100,000 in illegal payments. The balance of the deficiency ($14,500,000) resulted from adjustments to standard items attributable to Corporations D, E, F and P. In addition, the Service determined that the civil fraud penalty (§6653(b)) was applicable. Under current Service policy, the civil fraud penalty is applied to the entire consolidated deficiency as follows:

Deficiency	$15,000,000
50% Civil Fraud Penalty	7,500,000
TOTAL	$22,500,000

Thus, as a result of being a member of an affiliated group joining in an election to file a consolidated return, the illegal payments made by one corporation resulted in a geometric escalation of the civil fraud penalty (i.e., by $7,475,000).

11. Q. Can illustrations be cited showing how an individual with very moderate income might be adversely affected by the present application of the civil fraud penalty?

A. Yes. The examples cited in answer to question No. 8 involving two taxpayers, each of whom has an income of $10,000, certainly are examples of taxpayers who are not in the high income bracket.

Many other examples could be cited. Take the case of a farmer who suffered a bad year due to loss of crops from drought and storms. After deducting his items of expense, his tax return shows he owes no tax. However, one of the deductions that he claimed was for improvements that he made which he listed as an expense, but upon audit of his return, this particular deduction was denied and the transaction held to be a capital expenditure resulting in a deficiency of $1,000. Let us assume that he made a full disclosure of the transaction which the IRS held to be a capital expenditure instead of an ordinary expense. The taxpayer failed to report cash income from outside earnings and that this failure resulted in a deficiency of $100 and was held to be fraudulent. The amount of his civil penalty would be 50 percent of $1,000 plus $100, or $550. This is more than five times the amount of the item tainted with fraud.

12. Q. What is the answer to the taxpayer who says, "I pay my taxes and I fully report my income. I do not want the civil fraud penalty changed or lessened and have my taxes increased because somebody else is not paying his full share?

A. The civil fraud penalty should not be repealed. We should not make a change in reference to the civil fraud penalty that would encourage wrong-doing, and certainly where the facts warrant it, the criminal penalty should be imposed. It must be recognized, however, that our laws should treat all taxpayers equally and that the amount of the civil fraud penalty should reflect the magnitude of the fraud. Taxpayers who may be held to have fraudulently failed to report the same amount of income should not receive vastly different treatment in the imposition of the civil fraud penalty because of circumstances in connection with their tax returns which have no relation to fraud.

13. Q. Is the present law in the best interest of the United States government and is it good tax administration?

A. No. The following comments from reputable tax lawyers illustrate the need for a change in the civil fraud penalty.

An authority on tax law from up-state New York writes as follows:

> ". . .a penalty that operates in this manner impedes the settlement of tax cases. For instance, if a substantial deficiency has been proposed against a taxpayer, and only a small portion of it is attributable to fraud, and the balance of the deficiency is due to legal or technical adjustments that are susceptible to settlement, the taxpayer cannot settle the case without paying the fraud penalty on the total amount of the settlement deficiency. It has been my experience in this situation that the Agent or Appellate Conferee will not drop the fraud penalty, nor should he, since the taxpayer would not be penalized for a fraudulent transaction. Thus, both the Agent and the taxpayer's representative are faced with the dilemma of either compromising the non-fraudulent adjustment to take into account the amount of the fraud penalty on the entire deficiency, or going to trial."

A tax lawyer in Massachusetts with experience in handling the government's side of civil fraud cases, says:

> "In my judgement, present law works against the government's own interest in tax fraud cases. When I prosecuted criminal tax fraud cases as an assistant United States Attorney, I recall several defendants who wanted to plead guilty, but upon learning that the 50 percent fraud penalty would subsequently be applied to the entire civil deficiency for the year to which they desired to plead guilty, put the government to the expense of a trial."

A Missouri lawyer with long experience has this observation:

> "If the proposed provision (see the answer to question 14) was passed, I believe the Internal Revenue Service and the courts would be more inclined to assert and find fraud in such circumstances. The way it presently stands courts are reluctant to find fraud on a large deficiency while the fraud item was minor. It falls somewhat in the category of a statute which would provide for the death penalty in stealing $10.00. While such a penalty may inhibit some from stealing $10.00 it would also discourage juries from finding thieves guilty of the minor offense."

14\. Q. What is proposed in the way of change in reference to the civil fraud penalty?

A. The civil fraud penalty should be computed on the basis of the amount of the items that are tainted with fraud and it should not be computed on the total deficiency because that is placing a penalty upon the taxpayer who by happenstance has had included in his deficiency regular standard items which are not in any way tainted with fraud.

15\. Q. What has the Tax Section of the American Bar Association recommended in reference to the civil fraud penalty?

A. Since 1971 the Tax Section of the American Bar Association has continued to recommend that the Congress change the present statute so that the civil fraud penalty will be applied only to those items that are determined to be fraudulent. The Bar Association recommendation is as follows:

> Section 6653 The fifty percent fraud penalty should be based on only the portion of a deficiency resulting from fraud rather than on the total tax deficiency for the year. The taxpayer should, however, have the burden of proving the absence of fraud with respect to other items or adjustment <u>if the Service proves fraud with respect to any one item.</u>

16\. Q. Does this Bill S. , as the American Bar Association has recommended, apply the fraud penalty on only that portion of the deficiency resulting from fraud?

A. This measure does provide as the American Bar Association recommended that the 50% fraud penalty should be based on only the portion of the deficiency resulting from fraud rather than on the total tax deficiency for the year. However, this proposal goes further and increases the civil fraud penalty percentage from 50% to 100%.

As the Committee has learned from the testimony of the Chairman of the Tax Section of the ABA, this change has been urged for many years. I am impressed with the number of tax lawyers who have had long experience on the government side of fraud cases who believe that this change will result in sound tax administration and that its passage would be in the interest of the United States Government.

I would like to read from the statement of Mr. Terry Philip Segal, of Boston, who at one time was an employee of the Senate and later Assistant U.S. Attorney for the District of Columbia. Mr. Segal states, "In my judgment, present law works against the Government's own interest in criminal tax cases. When I prosecuted criminal tax fraud cases as an Assistant United States Attorney, I can recall several instances where defendants upon learning that the civil fraud penalty would subsequently be applied to the entire civil deficiency for an indictment year, put the Government to the time and expense and uncertainty of a criminal trial rather than plead guilty. I am persuaded that had S. 1594 been law when I prosecuted criminal tax cases, these defendants would have pleaded guilty." Mr. Chairman, I offer for the record the entire statement of Mr. Segal.

Mr. J. Richard Johnston, of Oakland, California, in a letter to Chairman Dole, says, "...I have been involved in federal tax work for 35 years; from 1946 to 1951 as a special attorney in the Penal Division of the Office of Chief Counsel of the (then) Bureau of Internal Revenue...The inequity of the present fraud penalty is so obvious as to require no explanation or argument; it simply bears no relationship to the extent of the fraud." Mr. Chairman, I ask that the entire letter of Mr. Johnston be printed in the record.

Mr. C. James Judson of Seattle, Washington, has written to Senator Symms, the introducer of S. 1594. In that letter Mr. Judson says, "...I have twelve years' experience in dealing with both civil and criminal tax fraud matters on behalf of taxpayers. These dealings have been both administrative before various levels of the Internal Revenue Service as well as in the courts. I have long been concerned about the civil tax fraud penalty provided by Internal Revenue Code Section 6653(b)(1) the so-called 50% fraud penalty....The punishment simply does not fit the proscribed action. For that reason it should be modified as provided in your S. 1594...I have represented taxpayers who have taken tax positions which the IRS has asserted are fraudulent, but where those tax positions have been substantially offset by accidental errors in favor of the Internal Revenue Service." Mr. Chairman I ask that Mr. Judson's letter be printed in full.

In a letter addressed to the Chairman of the Subcommittee, Mr. Charles M. Lock of St. Louis, Missouri, gives strong endorsement to S. 1594. Among other things he says, "...From 1967 to 1978 I was a trial attorney with Chief Counsel's Office, Internal Revenue Service, in St. Louis, Missouri. Since March, 1978 I have been a sole practitioner, specializing in civil and criminal tax law." Mr. Lock goes on to say, "...I believe the examples set forth in the Congressional Record dated October 5, 1981, adequately explains the inequity of Code §6653(b) as it pertains to individuals. Even though the public and lawmakers seem reluctant to grant tax relief to corporations we must remember shareholders are the true benefactors of a correction of an injustice in the tax law.

"In this day of divided responsibility it is extremely harsh to punish all shareholders for the impropriety of perhaps one individual who causes a false return to be filed. For instance, there may be ten individuals who have the responsibility for gathering the information necessary for filing a return. Nine of the individuals may do their best to insure an accurate return is filed. One of the individuals may be the cause of an item either not being reported or falsely deducted. Assume there is an honest dispute which results in a deficiency of $100,000. Assume further that the fraudulent item caused by the misguided employee accounts for a deficiency of only $1,000. Instead of the shareholders being the victim of a $500.00 penalty, they end up under the present law of being punished with a $50,500 penalty assessment. This could jeopardize the very existence of the business. Surely justice demands that shareholders be given protection under such circumstances." Mr. Chairman, I ask that Mr. Lock's letter be printed in full.

At an earlier date Mr. Lock had written me concerning the Civil Fraud Penalty and I would like to share a thought with the Committee from that letter. "If the proposed provision was passed, I believe the Internal Revenue Service and the courts would be more inclined to assert and find fraud in such circumstances. The way it presently stands courts are reluctant to find fraud on a large deficiency while the fraud item was minor."

This statement of Mr. Lock's is most significant when we consider that he was a trial lawyer with the Chief Counsel's Office for more than a decade. It supports our contention that this change would be in the best interest of the government.

Mr. Chairman, it is very basic to our tax law that taxpayers should have equal treatment. As the statute now stands two individuals each having failed to report outside income that they received in cash in an amount which resulted in a deficiency of $500, for each, and if one of these individuals had in his return an unintentional mathematical error which resulted in a $1,000 deficiency for him, the latter individual would face a civil fraud penalty of $750, while the first mentioned individual would face a civil fraud penalty of only $250. This is manifestly unfair. Under S. 1594 each would face a civil fraud penalty of $500.

Our tax system is based upon voluntary reporting of income by the taxpayers. If our laws are such that the IRS is able to treat all taxpayers with the ordinary simple rules of common justice the IRS will maintain the confidence and cooperation of the taxpayers. This in return will result in fewer problems, less expense for all, and a fuller reporting of income. The Congress should amend the law relating to civil fraud as provided in the bill before the Committee because it would bring better administration of our tax laws and because it is fair to all taxpayers, individual and corporation. I urge favorable consideration.

STATEMENT OF

JOHN S. NOLAN
CHAIRMAN, SECTION OF TAXATION

on behalf of the

AMERICAN BAR ASSOCIATION

before the

SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT

of the

COMMITTEE ON FINANCE

of the

UNITED STATES SENATE

concerning

CHANGES IN PENALTIES FOR CIVIL TAX FRAUD

November 6, 1981

Mr. Chairman and members of the Subcommittee:

I am John S. Nolan, Chairman of the Section of Taxation of the American Bar Association, an organization of 25,000 tax lawyers throughout the United States. On May 19, 1981, my predecessor, Harvie Branscomb, Jr., transmitted to the Committee on Finance the American Bar Association's recommendations for revision of the Internal Revenue Code provisions imposing civil penalties for fraud and for negligence. We recommended that the penalty in either such case should be based only upon the deficiency in tax attributable to items as to which there was fraud or negligence, rather than upon the entire tax deficiency as under existing law. A copy of that letter and its enclosures is attached to this statement. We reaffirm these views at this time.

American Bar Association Support For S.1594

S.1594, as proposed by Senator Symms, would carry out our recommendation that taxpayers should be given an opportunity to prove the absence of fraud as to particular items. To the extent the taxpayer is able to carry this burden of proof, the civil fraud penalty would apply only to the fraud-tainted items. S.1594 would also change the civil fraud penalty from 50% of the total deficiency to 100% of the deficiency attributable to items as to which the taxpayer has not carried the burden of proving an absence of fraud. This latter feature involves new considerations which the American Bar Association has not previously addressed before the Congress, and which will be discussed in this statement.

S.1594 would not change the fact that a civil fraud penalty would become applicable once the Government has proved that any part of an underpayment of tax is due to fraud. It would merely permit the taxpayer, subject to the burden of proof, to establish the absence of fraud with respect to particular items giving rise to the underpayment or deficiency in tax. If the taxpayer carries that burden of proof, the civil fraud penalty would not be applied to the deficiency attributable to the items giving rise to the deficiency as to which the taxpayer has proved there was no fraud. The civil fraud penalty would be based on the balance of the deficiency, as to which the taxpayer failed to prove that there was no fraud. This more refined application of the civil fraud penalty would be fairer; it would tend to eliminate unduly harsh and capricious effects of the existing penalty; and it would facilitate the settlement of cases without litigation.

Reasons For Change

The current civil fraud penalty can work unfairly because it can punish conduct which is plainly not wrongful. Consider a taxpayer with competent professional advice who takes a position on his tax return that subsequently turns out to be incorrect (e.g., the classification as an ordinary loss of an item which later is held to be a long-term capital loss). Ordinarily no penalty would or should attach to that conduct. If, however, there is also an unrelated fraud-tainted item on the taxpayer's return, current law will punish the taxpayer for the non-fraudulent mistake of his professional advisor as well as for the fraud.

The current civil fraud penalty violates the general principle that punishment should be commensurate with the offense. Section 6653(b) of the Internal Revenue Code applies a 50 percent penalty to the entire underpayment of tax whenever fraud is shown as to any single item. This provision can result in penalties that are disproportionately large compared to the amount of the fraud-tainted items. A small businessman can and should incur a civil fraud penalty for fraudulently disguising a non-deductible political contribution as a deductible business expense, but the penalty should not become many times larger because of a completely unrelated adjustment capitalizing some of his repair costs, or reducing his bad debt deduction, when there was no fraud of any kind involved in the repair cost or bad debt deduction item.

This problem is often exacerbated in the area of consolidated corporate tax returns. An affiliated group of corporations is permitted to file a consolidated tax return under §1501 of the Internal Revenue Code. Where, as is often the case, some members of the group operate independently from the other member~~s, it is~~ entirely possible for one member corporation to engage in civil tax fraud without the knowledge or complicity of the other members. In this situation, the civil fraud penalty under current law would nevertheless be applied to the entire tax deficiency of the affiliated group of corporations for which all the members would be liable. Thus the "innocent" member corporations are penalized on account of deficiencies resulting from non-fraudulent errors.

S.1594 would reduce or eliminate these types of inequities. The civil fraud penalty would still become applicable once the Government establishes that any portion of an underpayment is due to fraud, but the taxpayer would have the opportunity to prove that there was no fraud as to some items giving rise to the underpayment. The civil fraud penalty would then be more closely correlated with the extent of the taxpayer's fraud, resulting in a fairer, more consistent, and more uniform application of the penalty among taxpayers.

There is, however, some ambiguity in S.1594 in this respect. S.1594 would amend Code §6653(b)(1) to impose the penalty on "such portion of the underpayment" as is due to fraud. This provision contemplates that in appropriate circumstances -- such as the consolidated return situation described above -- the Internal Revenue Service could in the first instance assert the fraud penalty in respect of only a portion of the total underpayment. In these latter circumstances, where the Government establishes that a portion of the underpayment is due to fraud, the failure of the taxpayer to meet its burden with respect to other items alleged to be due to fraud should not result in the imposition of the penalty in respect of the entire underpayment; the penalty should apply only with respect to the portion of the underpayment as to which the Internal Revenue Service asserted the fraud penalty in the first instance. In other words, where the Internal Revenue Service makes an administrative determination at the outset that a portion of the underpayment is not due to fraud, the burden-of-proof rule should not operate to impose the fraud penalty in respect of such clearly untainted items. This result should be made clear.

As suggested, this change in the civil fraud penalty should bring more uniformity and consistency to the enforcement of federal tax laws. It is generally accepted that the courts and the Internal Revenue Service, recognizing the capriciousness of the current civil fraud provisions, often refuse to apply the 50-percent penalty where it would be grossly disproportionate to the extent of the wrongdoing or would be unduly burdensome. This exercise of discretion introduces inconsistency into the application of the penalty and forces a choice between the equally unsatisfactory alternatives of a penalty that is unduly harsh or a failure to penalize culpable behavior. For much the same reasons, the existing penalty provision lends itself to misuse as a lever to force possibly unwarranted concessions by the taxpayer in order to avoid overly-punitive effects from imposition of the fraud penalty.

Analysis of Opposition To S.1594

The Internal Revenue Service and the Department of Justice have asserted that S.1594 would diminish the *in terrorem* effect of the civil fraud penalty and would thereby reduce voluntary compliance with the tax laws. We do not agree. Of primary importance, it is the risk of criminal prosecution for tax fraud that supports voluntary compliance, and S.1594 would not lessen the risk of criminal penalties to any extent. Secondly, to some considerable extent, tax fraud is motivated by a desire to conceal other illegal activity. The magnitude of the civil fraud penalty will have little or no bearing on voluntary compliance in these latter cases.

Equally important, a taxpayer will never know in advance that the Internal Revenue Service will not assert fraud with respect to the whole deficiency. In making choices as to potentially fraudulent conduct, he is not likely to be weighing the fact that if the tax deficiency is enlarged on account of items as to which there is no fraud, and as to which he can prove there was no fraud even though (by hypothesis) there is fraud on his part to some extent, his penalty can be reduced.

We think further that S.1594 will actually facilitate the administration of the tax laws. During an audit or an administrative appeal of a case involving potential deficiencies in respect of both non-fraud and fraud-tainted items, the ability of the Internal Revenue Service to impose the fraud penalty selectively will encourage settlements by taxpayers. Furthermore, even where litigation occurs, it may facilitate stipulations by the parties as to many issues as to which they can agree there was no fraud by the taxpayer.

There is some legitimate concern that S.1594 would result in lengthier and more complex tax trials. This is due to the fact that where a taxpayer introduces evidence showing absence of fraud with respect to certain items, the Internal Revenue Service will be required to produce evidence to establish fraud with respect to each such separate item. Under existing law, the issue of fraud need be litigated with respect only to a single deficiency item in order to impose the penalty on the entire deficiency.

Our response to this assertion is threefold: First, we submit that expediency should not be given a higher priority than equity and consistency in the adminstration of our tax system. Although tax fraud is a gross violation of civic duty and responsibility and should be punished, the punishment must always bear a reasonable relationship to the extent of the violation. If criminal conduct is involved, severe criminal penalties may be imposed. The civil fraud penalty, however, is civil punishment, and as such should be applied fairly and uniformly.

Congress has again recently demonstrated the proper balancing of these considerations of expediency and equity: section 722(b) of the Economic Recovery Tax Act of 1981, in providing for an additional penalty measured by the interest payable on tax underpayments, limits this penalty to "the portion of the underpayment...which is attributable to the negligence or intentional disregard [of rules or regulations]."

Second, while recognizing that civil fraud cases proceeding to trial may well entail some additional complexity and some increase in trial time as a result of the proposal, we believe that the remedy provided by S.1594 will have the net effect of reducing the overall trial load in this area by encouraging settlement in the cases which now are forced to trial for the very reason that the taxpayer is given no acceptable alternative to the all-or-nothing approach of the present penalty provisions.

Third, where the evidence shows a clear-cut overall pattern of fraud, courts can be expected to offer no encouragement to allegations that specific items are exempt from the taint. In other words, where the taxpayer's fraud is pervasive, the courts are likely to impose a very heavy burden of proof on the taxpayer who seeks to show that some items leading to the tax deficiency involved no fraud. This is particularly likely to be true with respect to items omitted from the return, or items which are mislabeled or not adequately disclosed in the return.

Proposed Increase In Civil Fraud Penalty to 100%

Under S.1594, the civil fraud penalty would be increased from 50 percent to 100 percent. Presumably, this is done in recognition of the significantly smaller base for the penalty which might apply in cases affected by the bill. On the other hand, there will be taxpayers who have little or no possibility of meeting the burden of proof standards of the bill. Two specific examples would be those whose fraud is proven by the net worth (or bank deposit) method or whose principal fraud was failure to file a tax return. For them and others, the sole effect of this bill would be a doubling of the previous fraud penalty. As far as we are aware, no case has been made for the necessity to increase the fraud penalty in such situations. It is often particularly hard to prove a negative. No clear purpose is served by forcing taxpayers to try to prove a negative in order to avoid the much larger penalty that would be incurred under this bill by failing to prove an absence of fraud as to particular items.

Accordingly, we suggest that if it is decided to increase the penalty from 50 percent of the total deficiency to 100 percent on fraud-related items, there be a limit that the fraud penalty not exceed 50 percent of the total deficiency. Such a position is particularly necessary where the burden of proving lack of fraud is on the taxpayer.

Similar Revision of Negligence Penalty

The Subcommittee should consider similar reforms with respect to the negligence penalty under §6653(a). The current negligence penalty is 5 percent of the entire deficiency, rather than being limited to negligence-tainted items. The American Bar Association also recommends that the negligence penalty be restricted to negligence-tainted items. As pointed out earlier, §722 of the Economic Recovery Tax Act of 1981 adopted the concept of our recommendation by amending §6653 of the Internal Revenue Code to provide for an addition to tax which increases the current negligence penalty but which is restricted to negligence-tainted items.

Drafting Changes

We also suggest that consideration be given to two additional drafting changes in the bill.

1. The bill presently does not specify how the addition to the tax is to be computed. The specific recommendation of the American Bar Association proposes that the penalty be applied against the difference between the total tax deficiency and the tax deficiency computed without the fraud-tainted items or adjustments, so that the penalty would be applied to the portion of the deficiency computed at the highest applicable rates. To accomplish this objective, our recommendation proposes that the following sentence be added to §6653(b) as amended:

> For the purpose of this subsection, the part of any underpayment due to fraud shall be the difference between the total under-

payment and the amount of such underpayment determined without the inclusion of the fraudulent items or adjustments.

2. Section 6653(b) and (d) currently bars the imposition of a negligence penalty or a deliquency penalty in any case in which the civil fraud penalty is imposed. This rule proceeds from the premise that the fraud penalty will be applied to the entire underpayment. Under the provisions of S.1594, there is no reason not to permit the imposition of the negligence or deliquency penalty to any portion of the underpayment to which the fraud penalty is not applied.

Conclusion

We appreciate the opportunity of participating in these hearings. If we can be helpful in further consideration of this important matter, please call upon us.

AMERICAN BAR ASSOCIATION

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May 19, 1981

Senator Robert J. Dole
United States Senate
2213 Dirksen Building
Washington, D.C. 20510

Subject: Revision of Internal Revenue Code Pertaining to Fraud and Negligence Penalties

Dear Senator Dole:

During the course of testimony before the Senate Finance Committee on May 18, 1981, we were asked by Senator Symms whether an amendment to the provisions of the Internal Revenue Code relating to computation of fraud penalties was desirable.

The American Bar Association has determined that the provisions pertaining to the computation of the fraud and negligence penalties should be revised. Enclosed are our recommendations 1971-7, 1976-5 and 1969-2 to this effect.

Under our recommendations, the penalty would be based upon the underpayment of tax which is due to fraud or negligence, in lieu of the entire tax deficiency, as at present. We are aware of instances in which the item involving negligence was very small in a corporate tax return involving a great deal of income, and in which the negligence penalty was not imposed because the penalty would have been so far out of line with the offense. Our recommendations would make the penalty more closely related to the offense.

You will observe that the American Bar Association does not make a recommendation with respect to the rate which should be used in computing fraud and negligence penalties, if the statute is rewritten as we suggest. The officers of the Section recognize that the revision of the rate used in computing the penalty would certainly be an appropriate item for consideration by your committee.

The Section of Taxation recognizes the importance of appropriate provisions to assure compliance with our tax laws and was gratified to hear of the interest of your committee in improving the effectiveness and fairness of the provisions for penalties for fraud and negligence.

Sincerely yours,

Harvie Branscomb, Jr.

HB/bmh

Enclosures

Code Section 6653 Recommendation No. 1971-1

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO LIMIT THE CIVIL FRAUD PENALTY TO FRAUD TAINTED ITEMS

RESOLVED that the American Bar Association recommends to the Congress that the Internal Revenue Code of 1954 be amended to provide that the civil penalty for fraud shall be limited to 50 percent of that part of the underpayment due to fraud; that, in computing the fraud penalty, it shall be applied against the difference between the tax on the non-fraudulent amount subject to tax and the tax on the total, corrected amount subject to tax; and that the burden of proof shall be upon the taxpayer as to the absence of fraud after the Secretary or his delegate has met the burden of proof as to fraud with respect to any particular item or adjustment;

FURTHER RESOLVED that the Association proposes that these results be effected by amending sections 6653 and 7454 of the Internal Revenue Code of 1954;

FURTHER RESOLVED that the Section of Taxation is directed to urge the following amendments, or their equivalent in purpose and effect, on the proper committees of the Congress:

Sec. 1. Section 6653(b) of the Internal Revenue Code of 1954 is amended to read as follows (insert new matter in italics):

> (b) FRAUD.—If any part of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of *that part of* the underpayment *due to fraud*. In the case of income taxes and gift taxes, this amount shall be in lieu of any amount determined under subsection (a) *with respect to such part of the underpayment. For the purposes of this subsection, the part of any underpayment due to fraud shall be the difference between the total underpayment and the amount of such underpayment determined without the inclusion of the fraudulent items or adjustments.* In the case of a joint return under section 6013, this subsection shall not apply with respect to the tax of a spouse unless some part of the underpayment is due to the fraud of such spouse.

Sec. 2. Section 7454(a) of the Internal Revenue Code of 1954 is amended to read as follows (eliminate matter struck through and insert new matter in italics):

> (a) FRAUD.—In any proceeding involving the issue whether the ~~petitioner~~ *taxpayer* has been guilty of fraud with intent to evade tax, the burden of proof ~~in~~ *with* respect ~~of~~ *to* such issue shall be upon the Secretary or his delegate, *except that when the Secretary or his delegate has met the burden of proof with respect to any particular item or adjustment for any year or return, the burden of proof shall be upon the taxpayer as to the absence of fraud with respect to other items or adjustments for such year or return.*

Sec. 3. The amendments made by sections 1 and 2 shall apply to any underpayment of tax required to be shown on a return required to be filed after the date of enactment thereof.

EXPLANATION

Summary

The purpose of the Legislative Recommendation is to provide taxpayers with relief from inequities and excessive hardship which result, under present law, from computing the 50 percent fraud penalty on the entire amount of the deficiency (rather than only on the amount thereof due to fraud), in certain cases where there is a large total deficiency—as compared to a relatively small fraudulently caused deficiency.

The principal effect of the proposed legislative changes is to base the 50 percent fraud penalty on only the portion of the deficiency resulting from fraud with intent to evade tax, rather than on the total deficiency for the return involved. However, this will not limit the right of the Government to assert the negligence penalty on the remainder of the deficiency.

It is proposed that the penalty is to be computed on the difference between the tax on the non-fraudulent amount subject to tax and the tax on the total, corrected amount subject to tax.

A change is also proposed in the provisions relating to burden of proof in fraud cases, so that the burden will be on the taxpayer to prove the absence of fraud with respect to other items or adjustments relating to the return in question once the Government has met its burden with respect to any item or adjustment.

Discussion

Under present law, if fraud with respect to any item of income or other taxes is established by the Commissioner, the court is required to impose a penalty in the amount of 50 percent of the entire deficiency for the return involved. Thus, the fraud penalty applies to all adjustments for that return, irrespective of the fact that one or more of the adjustments may be clearly technical or otherwise non-fraudulent, and whether or not the false item or items constitute a material part or a minor part of the deficiency.

In theory, the fraud penalty has been construed by the courts to be remedial in nature, being designed to compensate the Government for the extra expense entailed in investigating and collecting the evaded tax. *Helvering v. Mitchell*, 303 U.S. 391 (1938). In practice, however, it is punitive. While it is not the purpose of this amendment to benefit or protect tax evaders, it would appear more equitable to make the fraud penalty commensurate with the magnitude of the fraud.

Where the fraudulent, or "tainted," items or adjustments are relatively small, the present rule may bring about extremely harsh and inequitable consequences. In the case of income taxes, it could even destroy a taxpayer financially, since with the application of the fraud penalty a whole string of otherwise barred years may be opened. This can occur when there is either a fraudulent omission of gross income or a deduction for fictitious or padded expenses or purchases in combination with substantial technical adjustments (such as depreciation, or capitalization of expenses), a good faith or negligent omission of income, or an innocent overstatement of expenses.

At present (and in fact since the Revenue Act of 1918), the deficiency on which the fraud penalty is based is the difference between the amount of tax determined to be due and the amount of tax shown on the original return. (Such return must be filed on or before the due date or any extension thereof. Otherwise, the penalty is computed on the entire tax liability.)

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO LIMIT THE NEGLIGENCE PENALTY TO NEGLIGENCE-TAINTED ITEMS.

RESOLVED that the American Bar Association recommends to the Congress that the Internal Revenue Code of 1954 be amended to provide that the negligence penalty be applied only to that part of the underpayment of tax which is due to negligence or intentional disregard of rules and regulations;

FURTHER RESOLVED that the Section of Taxation is directed to urge on the proper committees of the Congress amendments which will achieve the foregoing results.

REPORT

Summary

Under section 6653(a), if any part of an underpayment of income or gift tax is due to negligence or intentional disregard of rules and regulations, a five percent penalty is added to the tax. This penalty applies to the entire underpayment, even though only a portion of the underpayment may be due to negligence or intentional disregard of rules and regulations.

It is recommended that the penalty of section 6653(a) be based only on the portion of the underpayment resulting from negligence or intentional disregard of rules and regulations rather than on the total underpayment.

Discussion

Under section 6653(a), if any part of an underpayment of income or gift tax is due to negligence or intentional disregard of rules and regulations, but without intent to defraud, a penalty equal to five percent of the underpayment is added to the tax. Section 6653(c)(1) defines the term "underpayment" as a "deficiency". As defined in section 6211, a deficiency is the difference between the correct tax and the tax shown on the return, increased by prior assessments and decreased by rebates.

Section 6653(c)(1) further provides that the tax shown on a return referred to in section 6211(a)(1)(A) shall be taken into account only if such return was filed on or before the last date (determined with regard to any extension of time) prescribed for filing such return. Accordingly, Reg. § 301.6653-1(c) provides that an underpayment for purposes of section 6653 is either the total amount of all deficiencies as defined in section 6211, if a return was timely filed, or the correct income and gift tax imposed for the year, if a return was not timely filed.

The five percent negligence penalty under the present language of section 6653(a) applies to the entire underpayment or deficiency even though only part of it is due to either negligence or intentional disregard of rules and regulations. *Gaylord C. Peters*, 51 T.C. 226 (1968); *Bert Ruud*, T.C. Memo 1969-252. Thus if the Commissioner assesses a $100,000 deficiency against a taxpayer and only $20,000 of this deficiency is attributable to the negligence of the taxpayer, the five percent negligence penalty will be imposed against the entire $100,000 deficiency, for an addition to the tax of $5,000.

It follows that under present law situations may arise in which the five percent penalty of section 6653(a) may be imposed on a portion of a deficiency resulting from a mistake of law or fact made in good faith and based on reasonable grounds, if any other portion of the total alleged deficiency is due to negligence. There are many technical adjustments which are not remotely related to negligence but which may increase the total amount of the deficiency. In order to alleviate the present situation, which may lead to unduly harsh results where a relatively small portion of the deficiency is due to negligence, it is proposed that the section 6653(a) penalty apply only to that portion of the deficiency which is actually due to negligence.

This proposed change in the application of the negligence penalty also may be of assistance in the settlement of tax matters, in that it will provide the taxpayer and the Service with the opportunity to settle the issue of negligence on an item-by-item basis.

This proposal seeks to conform tax penalties with basic principles of fairness and equity. The proposal also parallels Recommendation No. 1971-1, which would limit the fifty percent fraud penalty of section 6653(b) to that part of the underpayment which is due to fraud.

This Recommendation deals solely with the problem of limiting the application of the negligence penalty to the tainted items. The originating committee considered whether, in view of the proposed limitation, the rate of the penalty should be increased, but decided that it should take no position on this question.

No member of the originating committee or of the Council of the Section of Taxation is known to have a material interest in this Recommendation by virtue of a specific employment or representation of clients.

PROPOSED STATUTORY LANGUAGE

RESOLVED that the Section of Taxation implement the foregoing by urging the following amendments, or their equivalent in purpose and effect, on the proper committees of the Congress:

SEC. 1. Section 6653(a) is amended to read as follows (eliminate matter struck through, insert new matter in italics):

(a) NEGLIGENCE OR INTENTIONAL DISREGARD OF RULES AND REGULATIONS WITH RESPECT TO INCOME OR GIFT TAXES.—If any part of any underpayment (as defined in subsection (c)(1)) of any tax imposed by subtitle A or by chapter 12 of subtitle B (relating to income taxes and gift taxes) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the ~~underpayment~~ *excess of—*

(1) the amount of the underpayment, over

(2) the amount of the underpayment determined by excluding the portion thereof which is due to negligence or intentional disregard of rules and regulations (but without intent to defraud).

SEC. 2. The amendment made by section 1 shall apply to assessments made after the date of enactment thereof.

EXPLANATION OF PROPOSED STATUTORY LANGUAGE

The proposed statutory language is self-explanatory. Conforming and clerical amendments have not been made.

Code Section 6653 Recommendation No. 1969-2

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO MAKE COMPUTATION OF THE CIVIL FRAUD PENALTY UNIFORM

Resolved, That the American Bar Association recommends to the Congress that the Internal Revenue Code of 1954 be amended to require computation of the 50 percent fraud penalty on the amount by which the tax due exceeds the tax shown on the delinquent return rather than on the entire tax due; and

Further Resolved, That the Association proposes that this result be effected by amending section 6653(c)(1) of the Internal Revenue Code of 1954: and

Further Resolved, That the Section of Taxation is directed to urge the following amendment, or its equivalent in purpose and effect, upon the proper committees of Congress:

Sec. 1. Section 6653(c)(1) is amended to read as follows (insert new matter in italics):

> (1) INCOME, ESTATE, AND GIFT TAXES.—In the case of a tax to which section 6211 (relating to income, estate, and gift taxes) is applicable, a deficiency as defined in that section (except that, for this purpose, the tax shown on a return referred to in section 6211(a)(1)(A) shall be taken into account only if such return was filed on or before the last day prescribed for the filing of such return, determined with regard to an extension of time for such filing, *or before notification by such means as the Secretary or his delegate shall designate, either that it cannot be determined whether a return was filed or that a return was not filed*), and

Sec. 2. This amendment shall be effective upon the date of enactment thereof.

EXPLANATION

Summary

The purpose of the proposed amendment is to eliminate the inequity caused by the current computation of the 50 percent fraud penalty on the entire tax due on a delinquent return rather than upon the amount by which the tax due exceeds the tax reported, provided such return was filed prior to the institution of an investigation by the Internal Revenue Service.

Discussion

Section 6653 provides penalties for underpayment of tax. It sets forth the so-called negligence penalty of 5 percent for negligence or intentional disregard of rules or regulations without intent to defraud. This section also provides a penalty of 50 percent of the underpayment if any part of the underpayment is due to fraud. Under § 6653(c)(1) the term "underpayment" is defined as a deficiency, which is itself defined elsewhere in the Code. A deficiency is defined by § 6211(a) as the tax due less the sum of the amount shown on the return plus amounts previously assessed. But by a specific exception, § 6653(c)(1) says that if a return is not timely filed (taking extensions into account) the fraud penalty is applicable to the entire tax due and not merely to the deficiency as defined in section 6211(a).

If a timely return is fraudulent, the 50 percent penalty applies only to the deficiency, but if a delinquent return is fraudulent, the 50 percent penalty applies to the entire tax due. This conflicts with the design of the Code under which a fraud penalty applies to the deficiency while a delinquency penalty applies to the entire tax. Since, in furtherance of the foregoing design, § 6653(d) provides that a delinquency penalty shall not be asserted if the fraud penalty is assessed, it is manifestly unfair to impose an additional fraud penalty on the taxpayer even where the return has been filed late without reasonable cause. A taxpayer who files his return even one day late is subject to a substantial penalty beyond the contemplation of the fraud penalty. Furthermore, the section to be corrected now imposes no greater sanction on the taxpayer who fraudulently fails to file a return at all and thus has neither declared income nor paid any tax. He is met with the assertion of the same penalty as the taxpayer who has, at least, filed a return, albeit delinquent.

This amendment presents an inducement to the taxpayer who has not yet filed, to comply voluntarily while under the present procedure, the taxpayer who fails to comply is accorded the same treatment as the taxpayer who makes some effort to do so. Under present law the non-filing taxpayer may never be discovered and even if he is discovered, he is no worse off than if he had filed. Thus present law fosters non-compliance.

Eliminating the parenthetical reference to § 6211(a)(1)(A) in § 6653(c)(1) would accomplish the same result as is intended in the amendment suggested here. However, a substantial portion of the Section's Committee on Civil and Criminal Tax Penalties felt that the amendment as now proposed is more desirable in that it gives added inducement to voluntary filing.

For that purpose and in order to conform with the reasoning in George M. Still, Inc., 19 T.C. 1072 (1953), an inducement is provided prior to the institution of an investigation by the Service for the filing of delinquent returns. See also, Charles F. Bennett, 30 T.C. 114, 123 (1958).

The proposed change would also bring about parity in the imposition of the 5% negligence penalty in requiring its application to the deficiency rather than the entire tax due in cases of late returns filed before notification.

Under the proposed amendment there would be no change with respect to the taxpayer who never files and whose failure to file is due to fraud with the intent to evade tax. There is also no change with respect to the taxpayer who files late and after notification of the delinquency from the Commissioner. In both of the foregoing cases, the fraud penalty is computed by taking 50 percent of the entire tax due rather than 50 percent of the deficiency. The proposal, however, would bar the imposition of the 50% fraud penalty where a completely accurate and correct return is filed late, but before notification, even if the lateness is due to fraud.

On the other hand, the proposed amendment gives the taxpayer who files late, but voluntarily, the same treatment with respect to penalties that it gives to other taxpayers, i.e., the delinquency penalty is measured, in the case of delinquency only, by the entire tax due, and in the case of fraud, by the deficiency. Present law achieves no purpose by placing the additional burden on a taxpayer already faced with a substantial fraud penalty. The increase in this economic burden is not justified in cases where he has made an effort to comply voluntarily although delinquently.

* * *

This recommendation was prepared by the Section's Committee on Civil and Criminal Tax Penalties. To the extent of the knowledge of the chairman of that committee, no member of the committee has a client with a personal interest in this recommendation.

Senator PACKWOOD. We will next move on to S. 1081, and we will start out with Mr. R. Randall Vosbeck, accompanied by Mr. Ratliff, Mr. Guy and Mr. Wilwerding.

Dave, Senator Mathias testified earlier on this, and if you have a statement, this would be an appropriate time.

Senator DURENBERGER. I thank you, Mr. Chairman. I do have a statement that I would like to have printed in full in the record. I am sure Mac did his usual eloquent and perceptive-of-the-problem job in explaining the rationale behind the bill.

[The prepared statement follows:]

PREPARED STATEMENT BY SENATOR DAVE DURENBERGER

Mr. Chairman, thank you for giving me this opportunity to testify at the hearings today on the Design Liability Supplemental Protection Act. For the architects and engineers of our nation whose liability continues to increase dramatically, this bill is obviously very important. However, this piece of legislation is also very important for the claimants who would be more likely to receive appropriate recompense for legitimate abuses. Today, many claimants find themselves the "victims" of hollow victories over firms unable to pay the damages they owe. So for both architects and engineers and for the people who use their services, this act is vitally important.

Mr. Chairman, we in the Senate are very much like members of the general public in that we don't often hear of the problems of this nature experienced by architects and engineers. While the news often contains accounts of spectacular awards doctors are forced to pay in malpractice cases, disasters such as the collapse of the passageways at the Hyatt Regency Hotel in Kansas City are very rare. Yet this tragic event, in which over 100 people lost their lives, vividly illustrates the potential liability that an architectural or engineering firm can face. A doctor's liability in a malpractice case is almost always limited to one person; in design liability, though, a single error can cause injury or death to hundreds of individuals.

I think it is very important to remember, Mr. Chairman, that when we discuss architects and engineers, we are generally not referring to corporate giants that can absorb their loses through their high volume of business. Rather, in designing and engineering, 80 percent of all firms have fewer than 20 employees, and many are just one or two person operations. And, of course the volume of their product is quite small compared with, for example, a chainsaw manufacturer who sells hundreds of thousands of those tools every year.

The cost of the liability insurance of these small businesses has escalated steeply with the number of claims. In 1960, only 12 claims were filed for every 100 insured parties. By 1960, the number of claims had increased to 20, and by 1981 it's estimated the rates will be 45 claims per 100 insureds. To illustrate further, a recent study by the American Consulting Engineers Council showed that its members have an average of one claim each 2.6 years.

Worst yet, many of these claims are frivolous and, by any measure, unfair—but they still consume a great deal of time and money, neither of which any small business in America has in great abundance during these days of high interest rates. Take, for example, a case from my own state of Minnesota.

In 1972, a Minneapolis consulting engineering firm specializing in soils and materials engineering conducted a very limited investigation on the *first* addition of a townhouse project. Later on, a *second* addition was added to the townhouse project, but this particular Minneapolis firm had absolutely nothing whatsoever to do with its construction. Later when dificiencies arose in the second addition, the tenants sued over thirty parties, including the Minneapolis firm that had absolutely nothing to do with the deficient construction. Attorneys for the major defendants fearing the real potential of a jury coming in with a verdict against them put together a tentative settlement offer of $600,000 on behalf of all named defendants. When the Minneapolis firm was approached for a $5,000 "contribution" to the settlement, they originally refused. At that point, the firm was informed that only those defendants contributing would be discharged as part of this group settlement, and that litigation would proceed against individual defendants not contributing to the settlement. In order to save many times the amount in legal fees, the Minneapolis engineering firm reluctantly contributed $1,000 to settle a case about a construction job they had nothing to do with. Total losses, including legal fees and lost billable time within the office of the Soils Engineer, came to almost $2,500. And their fee on the work on the first addition was only $500, paid 8 years earlier. Mr. Chairman, this

Minneapolis consulting engineering firm lost almost $2,500 because a project they knew nothing about and had nothing to do with was built poorly.

The costs in this example were most likely borne by the firm, not by any insurance company, since the average deductible on such policies is $8,000. Even with the high deductible, premiums are high—2.4 percent of the gross receipts of a recently surveyed group of consulting engineers. For firms under 10 people. The average was three percent.

These high premiums have forced many firms to "go bare"—to go without any insurance protection. The American Institute of Architects found in a recent survey of their California members that 49 percent had no coverage. A nationwide survey by the American Consulting Engineers Council showed that 46 percent of the firms with fewer than 25 employees had no coverage. Major claims against these firms would very likely bring bankruptcy to the firm and little or no relief to the claimant.

The bill I am supporting today will permit architects and engineers to deduct amounts placed into a design liability trust fund. Those with "severe service liability problems"—in other words those firms unable to get insurance coverage above $1 million or those firms who must pay premiums in excess of two percent of their gross receipts to obtain such insurance—would be allowed to deduct the lesser of: 1) five percent of gross receipts; 2) a cumulative 15 percent of average receipts; or 3) $100,000. Other firms would be allowed to deduct the lesser of: 1) two percent of gross receipts; 2) ten percent of average receipts over a rolling five year base; or 3) $25,000. When money is drawn from the trust fund to pay a claim, that amount would be included in income and a corresponding deduction would be made for the expenses paid. To protect against abuse, this bill requires that unauthroized deductions be subject to a ten percent penalty. Also, if a controlling interest in the firm is sold, the trust funds would be taxable.

Mr. Chairman, the architects and engineers of this country have currently demonstrated that they are suffering from a difficult situation that we in Congress can easily alleviate for them. Like all small businesses in this country, and perhaps even more so, engineering and architectual firms are suffering under brutally high interest rates and a sluggish economy. I sincerely hope that we will be able to provide this measure of relief for them in the very near future.

STATEMENT OF HON. DAVID DURENBERGER, A U.S. SENATOR FROM THE STATE OF MINNESOTA

Senator DURENBERGER. In my statement I cover one small example of the problem. I am sure we all think of issues like this in terms of the Hyatt Regency in Kansas City, and so forth. But let me give you just this one small example that I think is probably more persuasive in the long run of the need for this legislation.

In 1972 a Minneapolis consulting engineering firm which specializes in soil and materials engineering conducted a very limited investigation on the first addition of a townhouse project in the city. Later on in time a second addition was added to the townhouse project, and this firm had nothing to do with that in any way. When some deficiencies arose in the second addition, the tenants sued over 30 different parties, including the Minneapolis soil-testing firm. The attorneys, as usual, facing the real potential of a major jury verdict coming in against them, put together a settlement offer of $600,000 on behalf of all of the named defendants, and went to this little soil-testing firm and offered them a $500,000 contribution to the whole settlement which, of course, in light of a lack of liability, they were unwilling to do.

To make a long story short, they ended up paying $1,000 into the settlement, paying another $1,500 or so in attorneys fees, and so forth, for $2,500 that there was no reason whatsoever they should have been liable for. But this is typical, as you all know, of the problems confronted by architects and engineers and related professionals when any kind of problem like this occurs which leads to litigation.

The costs in the example I gave you were not borne by any insurance company, because the amounts involved were small enough to come under the deductibles, most of which are usually in the neighborhood of about $8,000. So I think, Mr. Chairman, that we are not whistling Dixie or whistling anything else in this kind of a situation. This is a very real problem, and we have chosen to address the problem in one of the best ways and one of the most appropriate ways in the light of tax policy generally that we know how.

I know this is an important issue. I appreciate very much your willingness to address the issue and to give it the time that it clearly deserves. And I look forward to the testimony of the witnesses here this morning to prove the case.

Senator PACKWOOD. Gentlemen, go right ahead.

STATEMENT OF WILLIAM R. RATLIFF, PRESIDENT, AMERICAN CONSULTING ENGINEERS COUNCIL

Mr. RATLIFF. Mr. Chairman, my name is Bill Ratliff. I come here as president of the American Consulting Engineers Council, about 4,000 engineering firms across the United States.

I won't get into the details of the bill because, as you said, it is a very simple thing. It allows establishment of a trust fund of pretax dollars to allow our firms to pay legal fees and possibly settlements in the smaller areas, that is, under $100,000, and to allow these firms to carry higher limits of insurance with the same premium dollar by raising their deductible. It is as simple as that.

Probably the most common question that I get on this problem is: Why are you different from other professionals? How do your needs differ from those of other professionals? And I think it comes down to this: Under today's tort law, a doctor, for instance, has a duty to his patient. He might have a duty to the patient's family. But it pretty much stops there. And for a doctor to carry insurance limits of $1 million or $5 million would seem to be a reasonable number, under those sorts of potential liabilities.

A lawyer has a duty to his client. But it pretty much stops there, and at least he knows the limits of those that might be claiming a duty. I think we only have to look at the recent Kansas City disaster to understand the potential liability of the consulting engineer. The vast majority of the structural engineers in the United States have under 10 people in the firm. They are very small businesses. The vast majority of those firms carry insurance with upper limits under $1 million because of the cost of that insurance. Because of the cost of early claims and legal costs, they carry deductibles down in the $8,000 to $10,000 range. This is because, as very small business, they can't afford to handle the small end by themselves.

The small structural engineer has a duty, in the case of a Hyatt or any other tall building or dam or water treatment plant or major structural facility. He has a duty to hundreds and potentially thousands of unknown persons. And, as you know, the claims in the Hyatt tragedy right now have totaled $3 billion. It is an enormous potential liability that is imposed on an engineer or an architect that is unknown, to my knowledge, to any other private practitioner of a profession.

I think that's what makes us different and, somehow, our firms must be able to protect themselves, to put aside some money to protect themselves in the early going in order that they can raise their deductibles and increase their insurance coverage. Certainly, they won't be be able to cover any $3 billion, but they can get much more coverage than they have now.

Thank you, Mr. Chairman.

Senator PACKWOOD. I am not sure the issue is are you different from doctors and lawyers. Indeed you are. But the question that is raised by Treasury and by others is: Why can't you cover it by normal commercial insurance and need the self-insurance fund that the others will not have, or will not have under this bill?

Mr. RATLIFF. I think it is what I just alluded to, and that is, the insurance is there; it is just that our potential upper limits of liability are so far greater than these other professionals, because of the magnitude of the numbers of people that we have a duty to, that we simply have to have a way to set aside some money so as to raise those deductibles.

We are different. The Tax Code right now says we are different, because we can't accumulate retained earnings past $150,000. We can't even do it in that manner and set it aside for protection.

Senator PACKWOOD. Let me ask you this: This is not unrelated to the bill we had in the Commerce Committee on product liability and self-insurance, where companies were having a very difficult time at a rational price providing auto liability insurance.

How on earth are you going to, even with this kind of a trust fund set aside, cover the potential liability of millions or hundreds of millions of dollars?

Mr. RATLIFF. Well, we are not. All that we can hope to do is do better. And as you know, of course, there is a vast compounding effect. If you raise your deductible from $10,000 to $100,000, the same premium dollar might go from $1 million to $10 million. I don't know that those numbers are correct, but the amount of coverage you can get if you raise that deductible almost seems exponential. And so we can do a far, far better job, Even though we certainly can't cover the potential liability we have.

Senator PACKWOOD. We see this, of course, in health insurance. Far and away the greatest portion of the cost are billings under a thousand dollars. If, indeed, you had medical deductibilities of $500 or $1,000, health insurance would be infinitely cheaper than it is today.

Mr. RATLIFF. Yes, sir. Thank you.

STATEMENT OF RANDALL VOSBECK, PRESIDENT, AMERICAN INSTITUTE OF ARCHITECTS

Mr. VOSBECK. Senator Packwood, I am Randy Vosbeck. I am president of the American Institute of Architects, a practicing architect in Virginia, a graduate of the University of Minnesota. With me today is Jack Wilwerding, a past president of the Minnesota Society of Architects, on my right. Obviously, we are here to go on record to support S. 1081, the Design Liability Supplemental Protection Act of 1981.

I think I would like to point out some of the changes that have taken place since we were here last—I think it was last September 1980. I think these developments make passage of this bill perhaps even more in the public interest.

Now, first, over the last 2 years there has been a really marked increase in the severity of claims and the frequency of claims. In 1978, 36 percent of all architects and engineers had claims against them. In 1980, 45 percent of all of the people covered by insurance have had claims. So that means that about half of all the insured can expect to have a claim in the next 12 months. That is dramatic, and it is obviously having a dramatic effect on the cost and availability of insurance for us. I know of many firms that have now just dropped out of the insurance business and are going bare, going without coverage. The percentage of uninsured architectural engineering firms is dramatically increasing each year.

The second change is the change in the insurance market and the ability of the insurance industry to respond to our needs. This really continues to concern us. Over the past 25 years there have been about 20 different insurance carriers that have entered this field, but now most of them have withdrawn. There are now only seven companies carrying professional liability insurance, and of those seven we know of three that have undergone some major corporate reorganization of late. And so the availability of insurance from many of these companies is really uncertain. So that obviously is having a dramatic effect on the costs and the availability.

Third, I would like to stress the state of the economy today, particularly the construction economy. It certainly has a relationship to the bill. Architects and engineers are always the first to feel the effects of an economic slowdown. As our clients put off construction plans, and, boy, they are doing that a lot these days, insurance premiums we pay, which are primarily based on a historical record of our fees, of our gross income, as our income obviously goes down, then, in this construction recession, the percentage of our professional liability costs dramatically increase, because it is based on history. So that is a major impact on us.

I think we all know that as the economy moves into some trouble times that construction claims—claims of all sorts, I guess, but I know construction claims—tend to increase in frequency and severity. Claims that normally would not have enough merit for most people to pursue are vigorously litigated in the hopes of attaining recovery from anyone and everyone involved in a particular project.

So we cannot avoid getting caught in the middle of these disputes. And even when these claims are frivolous and the design professional is ultimately cleared of any negligence, a great expense is involved in defending the case. I want to stress this and point out one more time the vast increase in this shotgun approach that design professionals are facing these days.

Finally, I would like to draw your attention to a few of the changes in the bill. As a result of some review of the Joint Committee on Taxation, a new provision was added: First money paid out on a liability loss comes from the trust fund. This will prevent anyone from taking a deduction for a contribution to the fund and then paying out the loss out of current income.

So, in conclusion, I would reiterate that this bill is in the public interest; it will help to assure owners and users of buildings that they will not go uncompensated in the event of an error or omission on the part of the designer; and, at the same time, the bill can provide some stability to this volatile professional liability market and to small business design firms that are most affected by the rising cost of insurance.

Thank you.

Senator PACKWOOD. Anyone?

Senator LONG. No.

Senator PACKWOOD. Dave?

Senator DURENBERGER. I wonder if the panel—are we going to hear one more witness?

Senator PACKWOOD. I am not sure.

Mr. GUY. Yes, sir.

Senator PACKWOOD. All right. Go ahead. I am sorry.

STATEMENT OF LOUIS L. GUY, JR., REPRESENTING THE NATIONAL SOCIETY OF PROFESSIONAL ENGINEERS, WASHINGTON, D.C., ACCOMPANIED BY A. J. "JACK" WILWERDING, SETTER, LEACH & LINDSTROM, MINNEAPOLIS, MINN.

Mr. GUY. Thank you, Mr. Chairman. My name is Louis Guy, and I am the immediate past treasurer of the National Society of Professional Engineers. I am simply here to indicate our support for 1081 and for the joint statement with which you have been provided. I would like to emphasize just a couple of points.

This situation is not static. It is getting worse. There is an increasing frequency of claims. Mr. Vosbeck mentioned the shotgun lawsuits. There is a growing tendency, I think, of lawyers to protect themselves against their own liability by enlisting everyone who had any connection with the construction project, so that we can drag into more and more suits where, ultimately, we are exonerated, but there is a substantial legal cost and perhaps a settlement cost involved.

We have very large deductible amounts already. This is due to the fact that we are already paying from 2 to 3 percent of our gross income for liability insurance, as the record shows. The net worth of our firms is very small in relation to the liability for our projects which affect so many hundreds and potentially thousands of people, and this bears directly, I think, on Senator Mathias's comment earlier that the consumers and the public interest will be benefited by this bill in that it facilitates improved coverage of our tremendous liability, thereby assuring payment of successful claims which would otherwise have simply caused bankruptcy of our firms.

With that, I will close my remarks.

Senator PACKWOOD. Let me ask you one question that Senator Mathias wanted posed: It has been suggested that S. 1081 be expanded to include the services of landscape architects. They are a separate body of professionals, apart from architects and engineers, and they are subject to licensing under State law. Do you think the services of landscape architecture follows in the ambit of S. 1981 and should be included in the definition of service?

Mr. GUY. Randy?

Mr. VOSBECK. Yes. I think maybe I can pick up that one. Let me just say that there are many design professionals that are included in a construction process, in the design process. There are landscape architects and surveyors and interior designers and planners, and the like. This bill should address those licensed professionals that do really have a significant risk of liability.

Whether or not any of these groups belong in the bill really depends upon whether they can demonstrate that they have a significant risk or liability. And if the landscape architects can demonstrate that, we certainly have no objection to their being included in the bill.

Senator PACKWOOD. Dave.

Senator DURENBERGER. One question to the panel, and I think probably the chairman of the subcommittee knows the answers because of the chairmanship of another committee that he has already referred to. But would you respond to the nontax mechanisms that might be available to us to address the problem and why you prefer this particular approach? I think, of course, of tort reform and contractual limitations on liability, the formation of risk-retention groups or association-owned insurance companies, and so forth, which we see in some of the other areas.

Mr. RATLIFF. I am not sure that I can respond to all of those. As far as the hold harmless protection by the owner, the problem that we encounter most of the time is that the contracting parties can hold us harmless—we can have a contract that holds us absolutely harmless from all of those parties involved in the beginning. But this won't keep third parties and fourth parties and seventh parties, in the example that you gave, from bringing us into a lawsuit, at costs to us of thousands of dollars, simply to prove we don't belong there.

Most of our problems these days are not a result, frankly, of anything we have done or have failed to do. They are a result of being around and having to prove that we don't belong in the lawsuit. I would say the majority of the claims in our cases are of that nature. And there is no one that can protect us against that, unless we have some better means by which we can defend ourselves, I think.

So far as association insurance, probably Randy could speak to that, since they are more deeply involved in that than we are.

Mr. VOSBECK. Well, there is a provision in the bill that eliminates any reference to captive insurers, if that is what you were referring to. It is really not realistic to expect that architects and engineers will be able to establish any kind of a captive insurance company as a substitute for commercial insurance. So I think that that should really eliminate any concerns of the insurance industry with regard to a loss of insurance to captive insurers.

I would like to comment, too, Senator Packwood, if I could, on your comment on self-insurance earlier. I think what this bill does is to really only put us on an equal footing from a self-insurance point of view. There are limits of contribution that are in the bill that really limit precisely what we can contribute with regard to self insurance, and this certainly will not replace the commercial insurance. It will primarily protect our deductibility portion that we have now.

Mr. GUY. Mr. Chairman?

Senator PACKWOOD. Yes.

Mr. GUY. On the risk retention or on the captive groups, I think they address, really, a problem of availability, and that isn't our problem. Our problem is we are already paying 2 to 3 percent of our gross income for this, and we are seeking to find a method that will enable us to be better covered. As far as changing the system, they might address the problem of widespread suits that bring in everybody and run up the costs. That really is a State problem, is it not? And it could take forever to solve on a State-by-State basis.

Senator DURENBERGER. That answers the question, Mr. Chairman. Thank you.

Senator PACKWOOD. Gentlemen, thank you very much.

[The prepared statements of the previous panel follow:]

AMERICAN CONSULTING
ENGINEERS COUNCIL

AMERICAN INSTITUTE
OF ARCHITECTS

NATIONAL SOCIETY OF
PROFESSIONAL ENGINEERS

JOINT STATEMENT
OF
THE AMERICAN INSTITUTE OF ARCHITECTS
THE AMERICAN CONSULTING ENGINEERS COUNCIL
THE NATIONAL SOCIETY OF PROFESSIONAL ENGINEERS
BEFORE THE
SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT GENERALLY
OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

November 6, 1981
Washington, D.C.

OUTLINE OF
AIA/ACEC/NSPE JOINT STATEMENT

Nature of Design Professions

- Professional services for the private sector, government and grantees.
- Small businesses.

A-E Liability Problems

- Victims of litigation-prone society.
- Numerous claims including third-party suits.
- Nature of insurance coverage and costs.
- Uninsured expenses of claims.
- Large numbers of design firms unable to afford insurance.
- Client requirements.

Legislative Remedy -- S. 1081

- Sponsors of bill.
- Utilization funds and permitted uses.
- Fund categories and contributions.
- Penalties for unauthorized distributions.
- Narrow scope for bill.
- Protection for trust assets.
- Revenue estimate.

Justification

- Design professions and built civilization.
- Make maximum use of A-E potential.

Conclusion

- Serious problems exist -- S. 1081 is a remedy.
- Congress can help A-Es and the public interest.

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AIA/ACEC/NSPE JOINT STATEMENT
IN SUPPORT OF S. 1081

Mr. Chairman and Members of the Subcommittee, representatives of the American Institute of Architects (AIA), R. Randall Vosbeck, President, the American Consulting Engineers Council (ACEC), William R. Ratliff, President, and Louis L. Guy, Jr., of the National Society of Professional Engineers (NSPE), appear before you in support of S. 1081, the Design Liability Supplemental Protection Act of 1981.

Who We Are

The American Institute of Architects (AIA) is a national organization comprised of approximately 38,000 members in some 11,500 firms employing an average of nine people each. The American Consulting Engineers Council (ACEC) is a national federation of approximately 3,800 private practice design engineering firms having 110,000 employees. The National Society of Professional engineers (NSPE) is a non-profit group representing over 80,000 engineers in government, construction, industry and private practice.

We and the other design professional organizations and their member firms are a labor-intensive industry employing state-licensed professionals and supporting staff to perform various construction-related architectural and engineering functions.

These include designing, surveying, planning, evaluating, making studies and inspecting construction projects as representatives of owners. A-Es are not construction contractors, but professionals who are retained by owners/clients. While much of our work is performed in the private sector, we also have direct contracts with governments at all levels, as well as with states and local communities under various federal grant programs.

Most engineering and architectural firms in the United States are categorized as small businesses. Many are one- and two-person operations. Seventy-five percent of the firms have fewer than ten employees. The average size of an architectural firm is nine. Seventy-nine percent of ACEC firms employ 25 or fewer; 90 percent of consulting engineering firms have fewer than 50 employees.

Architectural and engineering firms are typical of small businesses today, for they must struggle to overcome lack of capital, high inflation, rising costs and increasing litigation.

A-E Liability Problems

Ours is a litigation-prone society. One of the most serious difficulties facing design professionals is that of liability! A-E firms experience very real and very frustrating problems with liability claims and costs for protecting themselves from them.

A recent study by the accounting firm of Deloitte, Haskins and Sells (DHS) (copy attached) shows that one-third of all A-E firms, regardless of size, experienced liability claims over the past five years. This DHS study also found that as the size of the firm grows, so does the likelihood of experiencing claims. Two-thirds of the larger firms reported at least one claim during the same five-year period. A recent 1981 ACEC membership survey showed an average frequency of claims of one survey 2.6 years for the 1,408 firms responding.

These claims against A-Es are not always based upon alleged acts or errors by design firms, but include increasing numbers of third-party lawsuits where litigants attempt to collect from anyone with even a tangential relationship to the project. Even in cases where the prospect of a liability judgment is negligible, the central role of the design professional in the project obligates the architect or engineer to a legal defense. In a majority of such cases, the relationship of the case to the architect or engineer in responsible charge is tenuous and many times removed.

For example, the following case was brought to ACEC's attention by a member firm from Minnesota.

> "A few months ago we were named as 7th party defendent of the the 6th party plaintiff (or something like that). It seemed that the first plaintiff bought a house from the first party defendant which had another house encroaching on his lot. When he bought the house, he had a survey done by the city engineer who was moonlighting (doing surveying on the side) that showed the house encroaching on the property. With this knowledge the man still went ahead and bought the lot and then turned around and sued the guy he bought it from. He turned around and sued the guy who built the house, and he turned around and sued someone else, and then they turned around and sued the City for issuing a building permit - somebody was continually sueing someone else. Finally, it got to us.
>
> We had done the original underlying plat about 10 years ago. Our first impression was that they were alleging that someting was wrong with the original plat. As it turned out, that was not the case at all.
>
> When they went out and located their house on the lot, they saw some stakes with red flags on them and used those stakes as assumed property lines without having a survey done. It turns out that the stakes were put in as a control line by the City in doing some topographical work for another project in the next block. The reason that we were named is because nobody bothered to check on whose stakes they were and someone had seen a tan truck in the area and - are land surveyors who have 'tan' trucks. Therefore, they thought it must be us who put the stakes in.

> We had not been in that area for 8 years! Had nothing to do with any stakes being put in and as a result of this discovery we were excused from the law suit. However, we had to go through it until the discovery, take some depositions, and run up legal costs in order to get excused from the suit."

To help protect themselves, design firms carry substantial amounts of insurance. According to DHS, the average policy is \$449,000, with a deductible of \$8,000. The costs of insurance, the study revealed, are relatively more severe for smaller firms than for larger ones. The ACEC survey bears out these findings.

Liability premiums for all sizes of A-E firms are high, along with the levels of deductibles which firms must often accept in order to hold down the costs of insurance or raise their upper levels of coverage. The DHS study revealed that 95 percent of the firms surveyed believed that their liability insurance premiums are high. Further, 64 percent of the firms surveyed reported that their insurance costs exceeded two percent of their gross receipts. The ACEC survey showed the average amount of gross revenues spent for insurance was 2.4 percent, with firms of one to ten personnel spending about three percent. While this percentage seems small, in the context of profits averaging 5.3 to 11.8 percent of gross billings this figure is significant.

In testimony delivered to the House Committee on Ways and Means on a similar legislative proposal in 1978, a design community witness stated, "For many A-Es, 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."

Outside of insurance coverage, there are uninsured expenses for design firms facing claims. Since the vast majority of claims against architects and engineers are relatively small, this means that A-Es must pay as first costs claims and legal fees up to the levels of their deductibles from out-of-pocket. These uninsured first costs of liability can be especially destructive to small businesses. Because the deductible applies to each and every claim, multiple claims can dramatically increase the out-of-pocket costs. In addition, many of the risks experienced by architects and engineers fall outside the coverage of the policy.

Whether one wins or loses on a claim, there are always costs to the firm. In addition to the cash expenses referred to above, the A-E firm must absorb the costs of uncompensated professional time spent in investigation and defense preparation. Since the commodity sold by an engineer or architect, like any professional, is his or her time, a claim can result in a significant loss. A general rule of thumb is that the design professional will spend three hours of his own time in defending a claim for every hour spent by the attorneys.

The possiblity of liability claims does not end when a project is completed because many defects in a building or structure may not be discovered until years after it is completed. Liability coverage for design firms is written on a "claims-made" basis: insurance covers claims for errors, omissions or acts only during the actual term of the policy. Consequently, design firms must maintain insurance long after projects have been completed, even when their members retire from active practice.

In some cases firms could need coverage literally forever, since not all states have statutes of limitations!

Living with deductibles is another fact of life as design firms seek to help control expenses. Per the ACEC survey, nearly three-quarters of all firms of one to ten personnel responding accept deductibles of between $5,000 to $10,000. Yet current tax laws discriminate against those who accept high deductibles to reduce premiums or to raise policy coverage. Monies now paid into reserve accounts are not deductible as business expenses until actually paid on claims, though payments on insurance premiums are deductible.

The inequitable tax treatment of design liability insurance expense is compounded by growing requirements of certain federal, state and local government agencies that A-Es maintain specified amounts of liability coverage as a condition of contract. Similar requirements are on the increase among major industrial clients of architects and engineers.

Adding to the serious situations we have described above is the shocking finding by DHS that 24 percent of the firms surveyed have no liability insurance coverage. They are, to use industry vernacular, "going bare". Some areas of the country have even greater numbers unreported. An AIA membership survey, taken in 1979, showed that 45 percent of Texas and 49 percent of California architects are without insurance. The 1981 ACEC survey showed that some 46 percent of firms with from one to 25 personnel were uninsured.

A-E firms "go bare" largely because they cannot afford the insurance costs attendant to their work. Eighty percent of those firms surveyed by Deloitte, Haskins and Sells who do not now carry liability insurance reported that high cost is the major reason. This situation is more unfortunate and unhealthy. It may prevent consumers and others who have legitimate claims from collecting on them. It can also result in A-E firms being forced out of business when a claim does arise. Perhaps some suits which go on and on do so only because the firms may not have the means to settle claims.

Legislative Remedy

The memberships of AIA, ACEC and NSPE strongly urge passage of S. 1081. Introduced by Senator Charles McC. Mathias and co-sponsored by two members of this Subcommittee (Senators Bentsen and Long), Senator Durenberger of the full Committee and Senator Heinz, S. 1081 will help to deal with the design profession's liability problems. We believe that S. 1081, if enacted into law, will enable designers to supplement their insurance coverage so that they can then satisfy out of their own funds the claims and liabilities they face to users and to the public.

This imaginative approach will permit A-E firms to set up service liability trusts in order to meet the costs of settling legitimate claims and defending themselves when required. Contributions to the trusts would be tax-deductible as a legitimate business expense for a predictable liability.

It is important to understand that S. 1081 is not intended to replace insurance, but to supplement it. Senator Mathias and his co-sponsors have crafted a legislative vehicle with which design firms can accumulate reserves to settle legitimate liability claims and pay for legal defenses under the levels of their deductibles without seriously disrupting cash flows.

While only four percent of A-E firms now set-aside funds especially for service liablity, two-thirds of the firms surveyed by DHS indicated that they would establish design liability trust funds if Congress were to enact S. 1081. Fifty-eight percent of those queried reported that, with such a trust fund, as permitted under S. 1081, they would increase their deductibles under their insurance policies. They would then be able to increase their upper limits or to stabilize premium costs.

S. 1081 defines two categories of liability problems and provides corresponding levels of trust fund deductions for them. Taxpayers with "severe service liability insurance problems" are defined as both those who are unable to obtain $1 million of liability insurance and those who can obtain such insurance, but only at the cost of a premium in excess of two percent of their gross receipts for a year.

Those having "severe" problems would be permitted to make annual contributions limited to the lesser of: (1) five percent of the taxpayer's gross receipts for the year from activities which might give rise to service liability; (2) a cumulative limitation equal to 15 percent of the taxpayer's average gross receipts (based on a five-year moving average) from such activities, minus any amounts already contributed to the account in prior years by the taxpayer; or (3) $100,000.

All other taxpayers would be limited to deductions equal to the lesser of: (1) two percent of the current year's gross receipts; (2) ten percent of the average receipts during the five-year base period, minus prior-year contributions; or (3) $25,000.

When a liability claim is made, monies must first come from the trust. This will insure that the impact of any tax deferred is minimized.

All distributions from the proposed service liability trust funds would be taxable when made. However, if the amounts are used by taxpayers to satisfy service liability claims, the taxpayer will be able to take an offsetting deduction. In order to discourage and penalize unauthorized distributions from trust funds (i.e., use of a trust fund for anything but service liability purposes), a ten-percent penalty tax would be added to the tax due on the amount of the distribution. It is clearly the intention of the bill's sponsor and the design community that use of the trusts established under the provisions of S. 1081 be limited solely to construction design profesionals licensed under state law.

To insure that a liability trust fund is adequately protected, limitations are placed on use of its assets. Service liability trust fund assets may be invested only in United States securities, state or local securities, bank deposits or other investments permitted to trustees or fiduciaries under state laws. Further, the assets of a trust cannot be invested in the business or the taxpayer establishing the trust.

Should any concerns arise as to the need for any additional limitations in the bill, we stand ready to assist in any modifications required to cover the situations.

While the problems of the design professions and their effects on society are very important when judging the merits of S. 1081, we would be remiss in not offering our best estimate of the "revenue loss" involved as a result of the tax defense of funds placed in the trusts.

Deloitte, Haskins and Sells estimates that the total amount of federal income taxes deferred under the provisions of S. 1081 for the first year is $50 million.

Justification For Enactment

Architectural and engineering firms are literally at the cutting edge of our built civilization. In the words of Senator Mathias when he introduced S. 1081, "The incredible technology that the design profession has fostered makes it the medium by which we shall create our future." We are here asking you and the Congress for help and consideration in recognition of the contributions architects and engineers have made and can make to the growth and development of our civilization.

It is often said that numerous professional practictioners, including those in law or medicine, are exposed to significant liabilty in their day-to-day acitivities. This gives rise to a question we hear frequently --- what makes the level of liability exposure higher for architects and engineers?

The doctor has a legal duty to his patient; a jury may also find that he has a duty to the patient's family as well, but ~~it~~ usually ~~ends~~ there.

Even the lawyer - he has a duty to his client, but no one else. He does not, according to recent case law, even have a duty to the person he is suing, even though he may approach that suit in a gross and inhumane fashion against the other party.

What about the design professional? For example, in the matter of the Kansas City Hyatt tragedy, is there a jury or court in the country who would find that the engineer responsible for the design of that walkway had no duty to the hundreds of people on the walkway or the dance floor that night? Very doubtful.

Clearly, as opposed to the doctor and lawyer, the architect's or engineer's duty, and corresponding potential liability to hun~~dreds, maybe even~~ thousands, of unknown persons is absolutely enormous. That duty and liability continues beyond design and, in fact, beyond project completion. In states without statutes of limitations, it continues indefinately.

We all know that doctors' patients sometimes die and lawyers' clients sometimes lose --- and we accept these realities. Yet the acceptable level of care for design professionals has come to be perfection. The public simply will not accept fallibility in the design of high-rise buildings, water purification plants, bridges, dams and other facilities.

The rates we as design professions pay reflect these realities. Premiums for design liability insurance are considerably higher than those paid by attorneys and physicians. So, unlike major manufacturers concerned with product liability coverage, insurance coverage is available to us, but the cost of such coverage for many in the design community is prohibitive, leaving many design firms underinsured and even uninsured. This is clearly not in the public interest.

The provisions of S. 1081 provide an effective remedy for such problems. By encouraging set-asides to satisfy small liability claims, design professionals are encouraged to raise deductibles and increase insurance coverage. And we believe they will.

But, more importantly, through implementation of S. 1081's provisions, the consuming public also gains a significant measure of protection--that it does not now enjoy.

Design professionals are vital to all that is built for our use. They create building space in which we work and live, develop energy sources, create transporation systems, promote energy conservation and do countless other services which many take for granted. A-Es are highly qualified, technically proficient individuals, trained through education and practical experience to develop the innovative ideas and plans that will provide a better environment for all of us.

Conclusion

We believe that serious liability problems threaten the design professions and inhibit making maximum use of their capabilities. Passage of S. 1081 will help to solve the very real liability problems of the small business-men and -women who comprise the design professions.

In essence, it will provide the necessary encouragement for them to set aside funds for future needs in years when they can afford to do so.

Passage of S. 1081 will also encourage the continued advancement of the art in architecture and engineering. In an era of growing scarcity of resources and rising costs the design community is the key to energy conservation, use of new materials, reduction of costs and development of better techniques. Needless to say, many significant design accomplishments of architects and engineers have involved elements of risk, yet they have vastly improved our quality of life. In the absence of this legislation, we might expect to see a growing trend toward the practice of "defensive" architecture and engineering -- blind reliance on outmoded techniques despite the fact that they have proven to be vastly inefficient in terms of resources, energy and labor use.

Mr. Chairman and Members of the Subcommittee, we thank you for this opportunity to present our views on what we consider to be a vital matter. We will be pleased to answer any questions.

Deloitte
Haskins+Sells

Appendix I

DESIGN PROFESSIONALS LIABILITY STUDY

Prepared for

THE AMERICAN INSTITUTE OF ARCHITECTS

and

THE AMERICAN CONSULTING ENGINEERS COUNCIL

July 30, 1980

Deloitte
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July 30, 1980

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President
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Dear Sirs:

Enclosed is our report on the Design Professionals' Liability Study that we conducted on your behalf. As more fully explained in our report, the study shows:

- The architect/engineering profession is dominated by small firms.
- The profession's liability problems are high insurance costs and claims experience.
- A large majority of firms favor federal legislation that would allow a tax deduction for contributions to a tax exempt professional liability trust.
- Over half of the firms that indicated an interest in the proposal said that their contributions would satisfy their liability needs.
- The estimated amount of federal income tax savings to be derived by the profession from the liability proposal for 1981 is $50 million. However, we estimate that within five years $32.8 million of this tax benefit will be recaptured as funds are used to satisfy liability claims and pay legal expenses.

We appreciate this opportunity to be of service to The American Institute of Architects and The American Consulting Engineers Council.

Very truly yours,

Deloitte Haskins & Sells

DELOITTE HASKINS & SELLS

DESIGN PROFESSIONALS LIABILITY STUDY

Prepared by

DELOITTE HASKINS & SELLS

for

THE AMERICAN INSTITUTE OF ARCHITECTS

and

THE AMERICAN CONSULTING ENGINEERS COUNCIL

July. 30, 1980

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INTRODUCTION

Earlier this year, The American Institute of Architects (AIA) and The American Consulting Engineers Council (ACEC) commissioned a survey to gather information about their members' professional liability problems. The survey was undertaken in response to the concern expressed by many architectural/engineering firms (hereinafter referred to as A/E firms) with the high cost of maintaining professional liability insurance.

The primary purpose of the survey, in addition to documenting the extent and magnitude of the professional liability problem, was to measure the utility of federal legislation that would permit A/E firms to establish a tax-exempt professional liability trust for payment of liability claims. A summary of this proposal is included in the questionnaire packet as Exhibit A.

Results of the survey are presented in this report in both summary and detail form. The results are focused on the following issues:

- Profile of the A/E profession.
- Nature of the professional liability problem.
- Views on the proposed legislation.
- Estimate of tax savings.

The report also includes a description of the survey population and tabulations of survey responses.

SUMMARY OF RESULTS

Profile of the profession*

The survey indicates that the profession is dominated by small firms. Sixty-four percent of the firms surveyed reported fewer than 10 employees and average annual gross billings of $135,000. Seventy-nine percent reported fewer than 20 employees and an average gross billing of $447,000.

The corporation was the predominant form of firm responding (48 percent of firms), with proprietorships second (35 percent of firms). Partnerships accounted for 16 percent of the response.

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* Because of the size of the 10 largest firms responding to the survey compared with the size of the other responding firms, it was necessary to exclude these 10 largest from the general survey results in order to present the results fairly. The responses of the 10 largest firms are presented in Exhibit C.

Nature of the professional liability problem

Over one-third of all firms reported at least one liability claim during the past five years. Analyzed further, we found that two-thirds of the larger firms (30 - 199 employees) reported at least one claim during this period. The number of claims reported shows a general increase as the size of the firm increases.

Seventy-six percent of the firms surveyed reported that they carry liability insurance. Of those firms, 46 percent said they carry it because of client requirements. Insurance premium costs, as a percentage of gross billings, appear to decrease as the size of the firm increases. For smaller firms, with one to nine employees, insurance premiums average approximately 3 percent of gross billings. This ratio decreases to approximately 2 percent for the larger firms with 30 - 199 employees. Sixty-four percent of the firms reported that their insurance costs exceed 2 percent of gross receipts.

Almost three-quarters (73 percent) of those firms surveyed believe that insurance premiums are very high; 22 percent believe them to be somewhat high, and 5 percent believe them to be moderate. None responded with the view that insurance premiums were somewhat low or very low.

Eighty percent of those that do not carry liability insurance reported that its high cost was the major reason for not carrying it. Only 9 percent said they did not have insurance because professional liability was not a concern.

Views on proposed legislation

Over two-thirds of the firms surveyed indicated that they would be likely to establish a tax-exempt trust. At present, only 4 percent of those surveyed reported that they set aside funds or create reserves for liability purposes. The major reason for firms expressing a lack of interest in establishing a trust is that they cannot afford to set aside the funds. Almost three-quarters of the firms that viewed the availability of funds as a major obstacle to utilization of the proposal were the smaller firms with one to nine employees.

Many firms reported that they would set aside significantly less than the maximum allowable amount. Overall, the firms indicated that they would set aside an average of between 2 and 3 percent of their present annual gross billings.

In response to an inquiry as to what firms would do about their insurance coverage once they established a liability trust, 58 percent of the firms indicated they would increase the deductible amount on their policy.

Estimate of tax savings

It is estimated that members of the A/E profession will save approximately $50 million in federal income taxes for 1981 by establishing professional liability trusts.

DETAILED ANALYSIS

Survey population and responses

A sample population of 2,366 firms was randomly selected from the membership lists of The American Institute of Architects and The American Consulting Engineers Council. Limited testing was performed on this sample population to detect any bias in size and location of the members selected. None was found. Questionnaires, together with a cover letter and an explanation of the proposed liability fund, Exhibit A, were sent to all those in the sample. Strict control was maintained in all phases of the survey to ensure the confidentiality of the respondents and their replies.

Five hundred and ninety-eight questionnaires were returned prior to the survey deadline. Thus, the response rate was just over 25 percent. Replies were summarized in a table, Exhibit B, to facilitate analysis of the results.

To ensure that the firms replying to the survey were representative of the memberships of their associations, the results were compared with known characteristics of those memberships. From this analysis we discovered that several quantitative results, such as average number of full-time employees and average annual gross billings, were higher than previous surveys had found. An investigation of the individual replies disclosed that there were 10 firms, five architectural and five engineering, which, because of their size, significantly influenced the results of the survey. Exhibit C provides a separate summary of the information received from the 10 largest firms. The disproportionate effect of the information supplied by these 10 largest firms distorted the characteristics of the majority of the firms replying to the survey. Therefore, in order to give a more representative picture of the survey replies, the information received from those firms has been excluded from all tables and information presented in the text of this report.

Profile of the profession

Form of organization

The following table gives an overall breakdown of the business form of the firms replying to the questionnaire.

Table 1

FORM OF BUSINESS ORGANIZATION

	Overall	Architects	Engineers
Proprietorships	35%	41%	18%
Partnerships	16	21	6
Corporations	48	37	75
Other	1	1	1

Corporations are the most predominant business form, particularly for the engineering firms. However, most architectural firms classified themselves as proprietorships, with corporations the second largest category.

Numbers of employees

To give an indication of the size of each firm, the questionnaire asked for the number of full-time employees of each firm replying to the survey. Table 2 illustrates the results of this question.

Table 2

SIZE OF FIRMS

Size of Firm (number of employees)	Percent of Firms
1 - 9	69
10 - 19	16
20 - 29	6
30 - 199	9
Total	100

The large majority of firms have few employees. Sixty-nine percent have one to nine employees and 85 percent have fewer than 20 employees.

These results closely parallel previous findings regarding the sizes of firms forming the membership of The AIA and The ACEC.

To illustrate, the 1979-80 profile of ACEC membership shows that 75 percent of member firms have fewer than 20 employees and 63 percent have fewer than 12 employees. In addition, a 1980 survey of consulting engineering firms, conducted by Consulting Engineer magazine, found that 78 percent of those firms had 25 or fewer employees and 55 percent had fewer than 10 employees. A limited survey of AIA membership conducted in June 1979 found that 78 percent of these firms had nine or fewer employees.

Types of services

Eighteen percent of architectural firms replying to the survey provided interior planning and some type of engineering service in addition to their architectural services. Seven percent provided construction management services and 6 percent said they provided other types of services.

Of engineering firms in the survey, 51 percent were involved in civil engineering, 66 percent in structural engineering, 38 percent in mechanical engineering, and 28 percent in electrical engineering. Fifteen percent were providing architectural services and 16 percent said they were involved in construction management.

Annual gross billings

Firms were asked to provide their annual gross billings for the preceding five years. The replies were averaged to obtain an average annual gross billing for each firm for the five-year period. The results were then summarized by firm size as shown in the following table.

Table 3

GROSS BILLINGS BY SIZE OF FIRM

Firm Size (number of employees)	Average Annual Gross Billings	Annual Gross Billing Range
1 - 9	$ 135,000	$ 1,000 - $1,400,000
10 - 19	447,000	87,000 - 1,385,000
20 - 29	722,000	175,000 - 1,462,000
30 - 199	1,440,000	384,000 - 4,900,000

The upper level of the gross billing range remains fairly constant for firms with up to 29 employees. As would be expected, the larger the firm in terms of full-time employees, the higher the average annual gross billings.

The average annual gross billing for all the firms replying to the survey was $350,000, reflecting the predominance of firms in the one to nine employee category.

Nature of professional liability problem

Claims history

Of the total number of firms replying to the questionnaire, over one-third have experienced liability claims. The following table reflects the percentage of firms experiencing liability claims.

Table 4

PERCENTAGE OF FIRMS EXPERIENCING LIABILITY CLAIMS BY SIZE OF FIRM

Firm Size (number of employees)	Percentage of Firms Experiencing Liability Claims
1 - 9	22
10 - 19	40
20 - 29	65
30 - 199	67

As the size of the firm grows, so does the liability claim experience. The frequency of claims reported by firms with over 20 employees is approximately three times that of the smaller firms with one to nine employees.

Firms were also asked how many liability claims they had experienced during the past five years. The following table summarizes responses by incidence of claims for the five-year period for firms that have experienced liability claims.

Table 5

INCIDENCE OF CLAIMS BY SIZE OF FIRM FOR FIRMS HAVING CLAIMS

Firm Size (no. employees)	No. of Claims experienced in the past 5 yr. period				
	at least 1	at least 2	at least 3	at least 4	5 or more
1 - 9	100%	34%	10%	5%	2%
10 - 19	100	47	21	8	5
20 - 29	100	53	21	10	-
30 - 199	100	67	55	32	30

Generally, as firm size increases, so does the number of claims reported by firms that have experienced claims. Only 2 percent of the smaller firms with claims reported more than four claims within the past five years, whereas 30 percent of the larger firms with claims experienced more than four claims during the same period. However, no firms in the 20 - 29 employee group reported more than four claims.

Firms were asked to give details of the dollar amounts of the claims they had experienced. This information is illustrated in the following table.

Table 6

AVERAGE DOLLAR AMOUNT OF CLAIMS EXPERIENCED BY FIRMS WITH CLAIMS

Firm Size (number of employees)	Average Dollar Amount of Claims Over the Past Five Year Period
1 - 9	$ 180,000
10 - 19	1,209,000
20 - 29	269,000
30 - 199	1,870,000

As pointed out earlier, no firms in the 20 - 29 employee group reported more than four claims. This experience is reflected in a disproportionately low average dollar amount of claims reported by this group.

Legal fees

Firms having liability claims were asked how much they had paid in legal fees relating to those claims over the past five-year period. The answers to this question were stratified by size of firm and are presented in the following table.

Table 7

LEGAL FEES BY SIZE OF FIRM

Firm Size (number of employees)	Average Legal Fees for Past 5 Yr. Period	Legal Fee Range for Past 5 Yr. Period
1 - 9	$ 5,000	$2,000 - $ 30,000
10 - 19	8,000	1,000 - 26,000
20 - 29	8,000	1,000 - 14,000
30 - 199	20,000	1,000 - 130,000

Average legal fees, as reported, increase as the size of the firm increases. Annual legal fees average approximately $2,000 per firm.

Insurance

Firms were asked whether they carried professional liability insurance and, if they did, whether it was carried because of client requirements. Seventy-six percent of the firms surveyed indicated that they did carry professional liability insurance. Forty-six percent of these firms carried the insurance because of client requirements.

Firms carrying liability insurance also supplied information about their insurance policy limits, deductible amounts, and premiums over the past five years. The results were averaged to obtain annual figures for purposes of interpretation. The average yearly policy limit was $449,000 and the deductible amount averaged $8,000. Only 12 firms reported coverage in excess of $1 million. In the case of premium costs, the replies were broken down by firm size and compared with average annual gross billings. The following table reflects the results.

Table 8

AVERAGE PREMIUMS AND
COMPARISONS TO GROSS BILLINGS BY SIZE OF FIRM

Firm Size (no. employees)	Average Premium	Average Gross Billings	Premiums/ Billings
1 - 9	$ 4,000	$ 135,000	3.0%
10 - 19	12,000	442,000	2.7
20 - 29	16,000	722,000	2.2
30 - 199	30,000	1,440,000	2.1

The highest premium to gross billing ratio is experienced by firms in the one to nine employee category, the smallest in size. Then, as firm size increases, the premium/gross billing ratio decreases. However, in no size category does this ratio fall below 2 percent for firms with fewer than 200 employees.

The results of the survey show that 64 percent of the responding firms pay in excess of 2 percent of their gross receipts for insurance premiums. For the smallest firms with one to nine employees, premiums reported were as high as 37.5 percent of gross billings; 78 percent of these firms reported premiums in excess of 2 percent of gross billings.

Firms that carry liability insurance were asked their view on its present cost. Seventy-three percent of the firms believe that insurance premiums are very high, 22 percent believe them to be somewhat high, and 5 percent believe them to be moderate. None responded with the view that insurance premiums were somewhat low or very low. Thus, in total, 95 percent of those that carry liability insurance feel the cost is at least somewhat high.

For firms that do not carry liability insurance at present, 80 percent gave high cost as their main reason for being uninsured. Only 9 percent said it was because professional liability was not a concern, and only 2 percent said they could not obtain the desired coverage.

Reserves

Only 22 firms of the 588 surveyed indicated that they currently set aside funds or established reserves. This amounts to less than 4 percent of the firms. In total, these firms reported that they set aside or reserved $166,000 annually.

Views on proposal

Firms that would use proposal

Firms were asked whether they would be likely to establish a tax-exempt liability trust to partially or fully self-insure against liability losses. A detailed breakdown of their responses is given in the following table.

Table 9

VIEWS ON PROPOSAL

Size of Firm (no. employees)	Percent Likely to Utilize Trust
1 - 9	62
10 - 19	77
20 - 29	87
30 - 199	78
For all Firms	67

Overall, two-thirds of all firms responding to this question indicated that they were likely to establish a professional liability trust.

Upon further analysis of these results, we found that of the firms experiencing liability claims, 76 percent said they would use the proposed trust. Sixty percent of those that did not have a history of claims said they were likely to use the trust. Thus, there is a high acceptance of the proposal regardless of a firm's claims history.

Fifty-six percent of those firms that do not carry liability insurance at present favored the proposal; over two-thirds of those that said the present cost of their insurance is very high indicated they would probably use the trust.

Firms that would not use the proposal

Those who replied 'no' to establishing a professional liability trust were asked to rank their reasons in order of importance. A ranking of 'one' was assigned to the most important reason, 'two' for the next most important, and so on. The following table shows the proportion of firms not likely to establish a professional liability trust voting for that particular reason within a ranking.

Table 10

ANALYSIS OF WHY FIRMS WOULD NOT USE A PROFESSIONAL LIABILITY TRUST

Reasons for Not Establishing Trust	Ranking of Reasons by Firms Not Likely to Establish a Trust			
	1	2	3	4
Professional liability not a concern	6%	5%	5%	10%
Prefer commercial liability insurance	12	18	16	13
Could not afford to set aside funds	49	24	8	7
Tax benefits not sufficient incentive	10	32	27	20
Tax penalty on unauthorized distributions	12	8	19	20
Permissible investments for funds not acceptable	1	7	22	23
Other	10	6	3	7

The major reason for firms not using the proposed trust is that they cannot afford to set aside the funds. Preference for commercial liability insurance and the tax penalty on unauthorized distributions rank as the second most important reasons for not being likely to use the trust. A significant percentage of firms indicated as their second most important reason that the tax benefits of the proposal are not a sufficient incentive to set aside funds. A very low percentage of firms indicated that their reason was that professional liability was not a concern. The limitations on investments only became significant as the third or fourth reason for not being likely to establish a trust.

Amount to be set aside

The firms that indicated they would use a professional liability trust said they would set aside a total of $3,481,000 annually, amounting to an overall average of approximately $10,000 per firm. The replies from these firms were analyzed further to determine the amount which would be set aside by size of firm and the relationship to their gross billings. The results of this analysis are illustrated as follows.

Table 11

AVERAGE AMOUNT TO BE SET ASIDE AND COMPARISON TO GROSS BILLINGS BY SIZE OF FIRM

Firm Size (no. employees)	Average Annual Gross Billing	Average Amount Would Set Aside	Percent of Gross Billings Set Aside
1 - 9	$ 135,000	$ 4,500	3.3
10 - 19	447,000	10,500	2.3
20 - 29	722,000	17,000	2.4
30 - 199	1,440,000	29,000	2.0

The amount to be set aside as a percentage of gross billings is highest for firms in the one to nine employee category and lowest for firms in the 30 - 199 employee category. Each classification of firm by size would set aside at least 2 percent of their annual gross billings. Fifty-two percent of the firms responded that the amount they would set aside would be sufficient to cover their needs.

Action to be taken on insurance coverage

Firms in favor of establishing a professional liability trust were asked what they would do with their present insurance coverage. The following table summarizes their replies.

Table 12

INDICATED CHANGES IN INSURANCE COVERAGE

Actions With Regard to Present Insurance	Percent
Raise deductible	58
Raise policy limit	19
Lower policy limit	12
Discontinue commercial coverage	11

Most firms (58 percent) would raise their deductible amount. Raising of the policy limit is the second choice and lowering the policy limit the third. These results indicate that firms are more likely to retain their present insurance policies, while altering their terms, rather than discontinue their insurance coverage altogether.

Estimate of tax savings

If the proposed professional liability trust legislation, as outlined in the survey, is enacted with an effective date that would allow its use for taxable years beginning after December 31, 1980, the expected federal income tax savings for members of the A/E profession for 1981 is approximately $50 million.

The proposal is designed to encourage firms to set aside funds for future liability losses and expenses by allowing a tax deduction at the time the funds are set aside instead of at the time the losses and expenses are incurred. Because of this, the tax benefit derived in 1981 is not permanent but rather is an acceleration of deductions that would otherwise be allowable in the future years when the losses and expenses are actually incurred. This acceleration of tax deductions amounts to a deferral of income tax payments. At the time the trusteed funds are used to satisfy these losses and expenses, the deferral is terminated.

Based on the history of claims reported in the survey over the last five years, it is estimated that $25.8 million of the initial $50 million tax deferral will be terminated as it is used to pay liability claims within the first five years of the proposal's existence. Furthermore, based on the history of legal fees paid as reported in the survey, it is estimated that $7 million of the 1981 tax deferral will be terminated within the same period. The methodology used to make these estimates is explained in Exhibit D.

EVALUATION OF RESULTS

The A/E profession is dominated by small firms. The nature of the professional liability problem projected by the firms appears to be twofold. First, they clearly expressed the view that insurance costs are high. This was especially true for the smaller firms. The second part of the problem is the claims experience. As the size of a firm grows, so does the likelihood of experiencing claims. Although insurance costs and claims experience are problems expressed by all sizes of firms, the relative importance appears to shift from insurance costs to actual claims as the size of the firm increases. A large majority of firms favor federal legislation that would allow a tax deduction for contributions to a tax-exempt professional liability trust. This is true whether or not the firms currently have insurance or have experienced claims. If the legislation were enacted, most firms would qualify as having a severe liability problem. Over half of the firms that indicated an interest in the proposal said that their contributions would satisfy their liability needs, although only a small percentage said they would discontinue commercial coverage.

Exhibit A

THE AMERICAN INSTITUTE OF ARCHITECTS

AMERICAN CONSULTING ENGINEERS COUNCIL

DESIGN PROFESSIONALS LIABILITY STUDY

May 9, 1980

Dear Member:

The high cost of maintaining professional liability insurance is a concern shared by many firms in the architectural/engineering profession. For some, the financial burden posed by escalating premium costs is considerable.

In our continuing efforts to serve the best interest of the profession and the public, AIA and ACEC have initiated an in-depth study of the professional liability insurance problem and possible solutions to that problem. One of these solutions is set forth in proposed federal legislation that would permit design professionals to set aside a portion of pre-tax income from services to pay any ultimate liability resulting from those services. The amount set aside would be placed in a tax-exempt professional liability trust. Attachment 1 explains the provisions of the legislation in greater detail.

But before we proceed with our legislative strategy, we must be able to provide the Congress with a better view of the scope of the problem and the viability of the solution. First, we need to verify the extent and magnitude of the liability insurance problem among profession members. Second, we need to measure the potential utility to firms of the method set forth in the proposal.

To do this, we have engaged the firm of Deloitte Haskins & Sells to conduct a survey of our membership. The survey is designed to provide the documentation we need to secure strong congressional backing for our legislation. Your prompt response is essential to the success of our efforts.

1735 NEW YORK AVENUE, N.W. • WASHINGTON, D.C. 20006 • (202) 626-7300

To ensure the confidentiality of the information your firm provides questionnaires will be returned directly to Deloitte Haskins & Sells for tabulation. In no case will specific date from firms be disseminated.

We think the time it will take you to complete the questionnaire will be well spent. We know it will help us better serve you and other members of our profession. Because you are part of a selected sample of architectural/engineering firms, it is important that you respond.

We ask that you please return this questionnaire directly to Deloitte, Haskins, & Sells, 1101 Fifteenth Street, NW., Washington, D.C. 20005 no later than May 30, 1980. A self-addressed, business reply envelope is enclosed for your convenience.

Thank you for your cooperation.

Charles E. Schwing, FAIA
President
The American Institute
of Architects

George W. Barnes
President
The American Consulting
Engineers Council

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THE AMERICAN INSTITUTE OF ARCHITECTS

AMERICAN CONSULTING ENGINEERS COUNCIL

DESIGN PROFESSIONALS LIABILITY STUDY

AIA/ACEC PROFESSIONAL LIABILITY SURVEY

Description of Firm

1. Form of firm

   ____ proprietorship

   ____ partnership

   ____ corporation

   ____ other (specify) ______________________

2. Current number of full-time employees

3. Type(s) of services provided (check all that apply)

   ____ architecture

   ____ civil engineering

   ____ structural engineering

   ____ mechanical engineering

   ____ electrical engineering

   ____ interior planning

   ____ construction management

   ____ other (specify) ________

4. Annual gross billings of your firm for each of the last five years (please estimate if necessary)

   $__________1979

   $__________1978

$__________ 1977

$__________ 1976

$__________ 1975

Projected gross billings of your firm for 1980 and 1981

$__________ 1980

$__________ 1981

Insurance Coverage

5. Does your firm now carry professional liability insurance with a commercial insurance company?

   Yes _____ No _____

   If yes, is it carried because of client requirements?

   Yes _____ No _____

   If not, why not?

   ________ too costly

   ________ not able to obtain desire coverage

   ________ professional liability not a concern

   ________ other (specify) ____________________

6. Aside from insurance carried with a commercial company, does your firm set aside funds or establish reserves for liability claims?

   Yes _____ No _____

   If yes, how much on an annual basis? $__________

If your firm has carried professional liability insurance during any of the past five years, please answer questions 7,8,9 and 10.

7. Upper limit of policy coverage

   __________ 1979

   __________ 1978

   __________ 1977

   __________ 1976

   __________ 1975

8. Amount of deductible

__________1979

__________1978

__________1977

__________1976

__________1975

9. Amount of annual premium

__________1979

__________1978

__________1977

__________1976

__________1975

10. Do you feel the present cost of your firm's liability insurance is:

__________very high

__________somewhat high

__________moderate

__________somewhat low

__________very low

Claims History

11. Number of liability claims your firm has had, regardless of outcome, over the past five years:

__________1979

__________1978

__________1977

__________1976

__________1975

12. Amount, disposition, and cost of claims to firm and insurance carrier during the past five years (Please include all claims whether or not settled.) If necessary, attach a schedule.

Year of claim	Amount of claim	Method of settlement	Amount of settlement	Paid by firm	Paid by insurer
_______	$_______	__________	$_________	$______	$______
_______	$_______	__________	$_________	$______	$______
_______	$_______	__________	$_________	$______	$______
_______	$_______	__________	$_________	$______	$______
_______	$_______	__________	$_________	$______	$______
_______	$_______	__________	$_________	$______	$______

13. Estimate of legal fees paid by your firm to resolve liability claims for each of the past five years:

    _______1979

    _______1978

    _______1977

    _______1976

    _______1975

14. Has your firm ever experienced a liability loss that exceeded taxable income for the year the loss was incurred?

    Yes_________ No________

Views on Proposal

The questions that follow are designed to measure the potential utility to firms of a tax-exempt professional liability trust that could be used to partially or fully self-insure against a firm's liability losses. A description of this trust and the provisions that would govern its use are contained in Attachment 1. Please read it carefully before continuing with the questionnaire and refer to it when necessary for clarification.

15. Would your firm be likely to establish a tax-exempt liability trust as described in Attachment 1 to partially or fully self-insure against liability losses?

    Yes__________ No_________

    If not, why not? (if more than one reason applies, please rank in order of importance using 1 to indicate the most important reason, 2 for the next important, etc.)

_______professional liability not a concern

_______prefer commercial liability insurance

_______could not afford to set aside funds

_______tax deductions and tax-free accumulation of income not sufficient incentive

_______tax penalty on unauthorized distributions

_______permissible investments for funds not acceptable

_______other (specify)_______________________________

If you answered yes to the first part of question 15, please answer the remaining questions. If you answered no, you have completed the questionnaire. At your option, you may fill in the information requested in the final section of the survey. Thank you.

16. What amount do you think your firm would contribute annually to a tax-exempt liability trust (within the allowable limits)?

$_______________

Do you think this amount would be sufficient to cover your professional liablility needs?

Yes__________ No________

17. If your firm established a tax-exempt liability account, which of the following actions would you be likely to take regarding your present commerical liability insurance? (check all that apply)

_______no commercial coverage at present time

_______discontinue commercial coverage

_______lower policy limit

_______raise deductible

_______raise policy limit

_______other (specify) _______________________________

Optional Information

The following information is requested but not required

Firm name____

Address____

Telephone____

Principal Contact_______________________________________
(name) (title)

Attachment 1

Summary of Professional Liability Legislative Proposal

The purpose of this proposal is to allow architectural/engineering firms a limited tax deduction for funds set aside to satisfy professional liability claims and associated expenses, such as attorneys' fees, incurred in defending or settling such claims. Each firm would be permitted to establish a trust into which the funds would be deposited. The funds of the trust would be invested in low-risk investments such as government securities or government-insured bank accounts. In no case could such assets be invested in the business of the firm establishing the trust. Income earned on the trust investments would be tax free. All funds withdrawn from the trust would be taxable. However, if a firm used trust funds to satisfy liability claims or associated expenses, it would receive an offsetting tax deduction. If it used trust funds for other than liability purposes, a substantial penalty would be imposed in addition to the regular tax. In addition, if controlling interest in a firm with a liability trust were sold or the firm ceased to exist, all amounts in the trust would be subject to regular income tax.

The major benefit of establishing a professional liability trust would be the tax-free accumulation of income on funds set aside to satisfy claims. The major disadvantage of establishing the trust is the loss of the current use of the funds for the operations of the firm or distribution to the principals.

The amount of a firm's annual deduction would be determined by the severity of its liability insurance problem. Firms that are unable to obtain $1 million of liability insurance coverage at a premium cost not exceeding 2 percent of annual gross receipts would be permitted to deduct the lesser of 5 percent of the current year's gross receipts from services or $100,000. This deduction would be permitted until the firm accumulated a fund equal to 15 percent of its average annual gross receipts from services (based on a five-year moving average).

All other firms would be permitted to deduct the lesser of 2 percent of the current year's gross receipts from services or $25,000 until the firm accumulated a fund equal to 10 percent of its average gross receipts from services (based on a five-year moving average).

The following table may help you determine your annual deduction.

Firms With Severe Product Liability Insurance Problem
Insurance Premium for $1 Million of Coverage
Exceeds 2% of Gross Receipts

Gross Receipts	Annual Deduction	Overall Limitation
less than $2,000,000	5% of current gross receipts	15% of average gross receipts
$2,000,000 or more	$100,000	15% of average gross receipts

Firms with Non-Severe Product Liability Insurance Problem
(Insurance Premium for $1 Million of Coverage
Does Not Exceed 2% of Gross Receipts)

Gross Receipts	Annual Deduction	Overall Limitation
less than $1,250,000	2% of current gross receipts	10% of average gross receipts
$1,250,000 or more	$25,000	10% of average gross receipts

AIA/ACEC SURVEY

Exhibit B

Summary results for respondents excluding ten largest firms

Total questionnaires returned — 588

Firm profile

	No. Firms	%
Proprietorship	204	35
Partnership	97	16
Corporation	281	48
Other	6	1

	No. Firms	Total	Average
Full-time employees	550	6,441	12
Annual gross billings	576	$201,669,000	$350,000
Projected 1980 annual gross billings	555	$274,166,000	$494,000

Claims History

	No. Firms	%
Firms with liability claims	194	34
Firms without liability claims	381	66

Number of claims experienced over past five year period — 425

	No. Firms	Total	Average
Legal fees over past five year period	173	$ 1,391,000	$ 8,000

Number of firms experiencing liability loss greater than taxable income — 14

Claims history, continued

Amount of claims over past five year period

No. Firms	Total	Average
146	$103,521,000	$709,000

Insurance

Carrying liability insurance

	No. Firms	%
Yes	440	76
No	142	24

Because of client requirements

	No. Firms	%
Yes	200	46
No	235	54

Reasons why firms do not have insurance

	No. Firms	%
Too costly	128	82
Not able to obtain desired coverage	4	2
Professional liability not a concern	15	10
Other reasons	10	6

Firms setting aside funds or creating reserves

No. Firms	%
22	4

Funds or reserves set aside

No. Firms	Total	Average
17	$ 166,000	$10,000

Insurance, continued

Policy terms:	No. Firms	Total	Average
Annual upper limit	452	$203,167,000	$449,000
Annual deductible amount	452	$ 3,801,000	$ 8,000
Annual premium amount	444	$ 4,370,000	$ 10,000

Views on present cost of insurance	No. Firms	%
Very high	324	73
Somewhat high	96	22
Moderate	25	5
Somewhat low	-	-
Very low	-	-

Views on proposal		No. Firms	%
Would establish a liability trust	Yes	382	67
	No	189	33

Major reason for not establishing trust	No. Firms	%
Professional liability not a concern	13	6
Prefer commercial insurance	26	12
Cannot afford to set aside funds	100	49
Insufficient tax incentive	20	10
Tax penalty on unauthorized distributions	25	12
Investments for funds not acceptable	2	1
Other	20	10

Views on proposal, continued

	No. Firms	Total	Average
Amount firms would contribute to trust	361	$3,481,000	$10,000

Is this sufficient to cover liability needs		No. Firms	%
	Yes	174	48
	No	185	52

Actions with regard to present insurance	No. Firms	%
Would discontinue commercial coverage	40	11
Lower policy limit	48	12
Raise deductible	220	58
Raise policy limit	74	19

VIEWS ON PROPOSALS

Would establish liability trust	80%
Amount would contribute (in total)	$ 125,000
Would discontinue commercial insurance coverage	Nil
Would raise amount deductible	63%

Estimate of Tax Savings
Methodology

Exhibit D

The estimate of federal income tax savings to be derived by the A/E profession from the professional liability proposal was made on the basis of the survey results, published statistics of income, and other data and assumptions provided by The AIA and The ACEC.

The survey responses were used to determine the percentage of firms that can be expected to utilize a professional liability trust and the amount they can be expected to contribute to such a trust. These data were stratified by firm size and projected to the entire population of A/E firms eligible to establish a professional liability trust. An adjustment was made for the large number of firms with income below the level at which it is expected trusts will be established. Another adjustment was made for firms that would derive minimum tax deferral because of the limitation on their deduction and the significance and frequency of their claims history. Marginal tax rates were assigned by size of firms on the basis of average billings and assumed deductions. These tax rates were applied to the amount that is expected to be contributed to professional liability trusts to arrive at an estimate of tax savings.

Historical data reported on claims experience and legal fees were correlated to amounts responding firms indicated they would contribute to the trust. The claims experience and legal fees of these firms were used to estimate the amount that would be includable in income as funds are withdrawn from the trusts to pay claims and legal fees over a five-year period.

Appendix II

SEPTEMBER 1981 FILE 308

ACEC 1981 PROFESSIONAL LIABILITY STATISTICAL REPORT

The data in this report were compiled from an ACEC membership survey undertaken in July. Similar data, developed from surveys from the past two years, have been included where comparisons were possible. The ACEC Liability Committee wishes to express its thanks to the respondents. In 1979 there were 1562 responses, 1705 in 1980, and 1408 this year.

This year the questionnaire was expanded and the resulting data are included in tables that give information both by fields of practice and size of firm.

So that you can compare your practice with the survey, here is how the fields of practice are defined:

Civil: Firms that practice general civil engineering specializing in environmental, municipal or transportation.

No. of firms in category: 594
% of all responses: 42%
Median staff size: 19

Mechanical/Electrical: Firms practicing only electrical or mechanical engineering, or both.

No. of firms in category: 302
% of all responses: 22%
Median staff size: 9

Structural: Firms that practice only structural engineering.

No. of firms in category: 203
% of all responses: 15%
Median staff size: 6

Geotechnical: Firms that practice only geotechnical engineering.

No. of firms in category: 51
% of all responses: 4%
Median staff size: 21

Architectural Engineering: Firms that practice architecture and two or more engineering disciplines.

No. of firms in category: 180
% of all responses: 13%
Median staff size: 49

Others: Firms offering services in disciplines or combination of disciplines other than those above; acoustical only; mechnical, electrical and structural; surveying only.

No. of firms in category: 65
% of all responses: 5%
Median staff size: 9

The number of responses by size of firms are as follows:

EMPLOYEES	NUMBER	%	EMPLOYEES	NUMBER	%
1 - 5	321	23	26 - 100	300	21
6 - 10	286	20	101 - 500	97	7
11 - 25	368	27	Over 500	23	2

INSURANCE DISTRIBUTION

	1979	1980	1981
DPIC	39%	38%	37%
CNA	16	18	19
Northbrook	18	16	14
INA	1	4	4
Other Carriers	9	9	13
Uninsured	17	15	13
Insurance Cost as a Percent of Gross for Insured Firms	2.9%	2.6%	2.4%
Requested More than One Quote last year	40%	50%	62%
Changed Carriers during year	10%	12%	11%

UPPER LIMITS OF LIABILITY - INSURED FIRMS

	1979	1980	1981
Under $100,000	N.A.	2%	1%
$100,000 - $250,000	N.A.	15	19
$250,000 - $500,000	N.A.	23	20
$500,000 - $1 million	N.A.	60	25
$1 million - $10 million	N.A.		23
Over $10 million	N.A.	N.A.	2
Raised Limits	9%	15%	16%
Lowered Limits	3%	3%	2%

DEDUCTIBLE - INSURED FIRMS

	1979	1980	1981
Under $5000	71%	25%	32%
$5000 - $10,000		44	39
$10,000 - $25,000	17	19	17
$25,000 - $100,000	12	12	10
Over $100,000	N.A.	N.A.	2
Raised Deductible	11%	11%	10%
Lowered Deductible	2%	3%	2%

CLAIMS INFORMATION - ALL RESPONDENTS

	1979	1980	1981
Claims made during year	489	711	530
Claims per firm ratio	.31	.42	.38
Claims Pending	809	1212	948
Claims pending per firm ratio	.52	.71	.67
Average amount of pending claim	N.A.	N.A.	$173,550
Total claims resolved	188	419	183
Resolved out of court	N.A.	328	163
Resolved by court judgment	N.A.	65	11
Resolved by arbitration	N.A.	28	9
Average cost per claim resolved	$22,975	$28,489	$25,682

INSURANCE DISTRIBUTION BY SIZE OF FIRM - 1981

EMPLOYEES	DPIC	CNA	NB	INA	Other	Uninsured
1-5	37%	12%	18%	2%	10%	21%
6-10	42	13	15	4	11	15
11-25	38	19	14	6	12	11
26-100	38	25	11	4	15	7
101-500	16	44	14	7	17	2
Over 500	18	44	4		30	4
All Firms Average	37%	19%	14%	4%	13%	13%

INSURANCE DISTRIBUTION BY FIELDS OF PRACTICE - 1981

FIELDS	DPIC	CNA	NB	INA	Other	Uninsured
Civil	31%	22%	13%	5%	13%	16%
M/E	42	18	20	3	10	7
Structural	63	10	10	2	10	5
Geotechnical	29	8	15		21	27
A/E	23	34	13	7	16	7
Other	26	11	12	1	19	31
All Fields Average	37%	19%	14%	4%	13%	13%

DEDUCTIBLES BY SIZE OF FIRM - 1981

	5,000 or less	5,001 10,000	10,001 25,000	25,001 100,000	Over 100,000
1-5	72%	23%	3%	12%	1%
6-10	45	50	4	1	
11-25	22	57	17	3	1
26-100	6	37	38	18	1
101-500	3	4	22	57	14
Over 500	5			27	68
All Firms Average	32%	39%	16%	10%	3%

DEDUCTIBLES BY FIELDS OF PRACTICE - 1981

	5,000 or less	5,001 10,000	10,001 25,000	25,001 100,000	Over 100,000
Civil	27%	38%	20%	13%	2%
M/E	47	41	9	2	1
Structural	42	51	6	1	
Geotechnical	11	11	47	26	5
A/E	10	31	24	23	12
Other	46	33	19	2	
All Fields Average	32%	39%	16%	10%	3%

LIMITS OF COVERAGE BY SIZE OF FIRM - 1981

	Under 100,000	100,000 249,000	250,000 499,000	500,000 1,000,000	1,000,000 9,999,999	Over 10,000,000
1-5	2%	40%	26%	20%	11%	1%
6-10	1	27	28	28	16	
11-25	1	14	26	29	29	1
26-100	1	5	8	28	57	1
101-500		1	2	8	80	9
Over 500			5		32	63
All Firms Average	1%	19%	20%	25%	33%	2%

LIMITS OF COVERAGE BY FIELDS OF PRACTICE - 1981

	Under 100,000	100,000 249,000	250,000 499,000	500,000 1,000,000	1,000,000 9,999,999	Over 10,000,000
Civil	2%	18%	19%	22%	37%	2%
M/E	1	27	27	25	20	
Structural		20	24	32	24	
Geotechnical		16	3	32	47	2
A/E		2	13	20	52	13
Other		36	16	23	25	
All Fields Average	1%	19%	20%	25%	33%	2%

INSURANCE COST AS A PERCENT OF GROSS BILLINGS

BY SIZE OF FIRM

	1980	1981
1-5	3.38%	3.00%
6-10	2.84	2.68
11-25	2.43	2.24
26-100	2.24	1.97
101-500	1.72	1.62
Over 500	1.43	1.45
All Firms Average	2.60%	2.36%

BY FIELDS OF PRACTICE

	1981
Structural	3.31%
Other	2.47
M/E	2.24
Geotechnical	2.24
Civil	2.23
A/E	1.82
All Fields Average	2.36%

AVERAGE FREQUENCY OF CLAIMS BY SIZE OF FIRM

FIRM SIZE	1979	1980	1981
1-5	N.A.	N.A.	1 every 8.9 years
6-10	N.A.	N.A.	1 every 6.9 years
11-25	N.A.	N.A.	1 every 4.5 years
26-100	N.A.	N.A.	1 every 1.9 years
101-500	N.A.	N.A.	1 every 7 months
Over 500	N.A.	N.A.	1 every 4 months
All Firms	1 every 3.2 years	1 every 2.3 years	1 every 2.6 years

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1735 New York Avenue, N.W.
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(202) 626-7300

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Senator PACKWOOD. We will conclude on this bill with a panel consisting of Brenda Viehe-Naess and J. Sprigg Duvall.

STATEMENT OF BRENDA R. VIEHE-NAESS, TAX COUNSEL, AMERICAN INSURANCE ASSOCIATION, WASHINGTON, D.C.

Ms. VIEHE-NAESS. Mr. Chairman, members of the subcommittee, I am Brenda Viehe-Naess, tax counsel of the American Insurance Association, a trade association representing 150 stock property-casualty insurance companies underwriting more than one-third of the property-casualty insurance premiums in the United States.

Thank you for including the complete copy of our written testimony.

The question whether to grant a deduction for amounts set aside for self-insurance of professional liability and product liability was considered at length by the 95th Congress. The proposal had been one of several recommendations for relief of a severe underwriting problem in product liability insurance made by the Interagency Task Force on Product Liability. After further consideration, Commerce Secretary Kreps announced that the administration had decided not to endorse the proposal. The reasons for the administration's objection were consistent with the objections of the Treasury Department earlier in this hearing.

In place of the special deductions for self-insurance reserves, a 10-year-loss carryback was adopted as part of the Revenue Act of 1978. At the same time this issue was before Congress, the American Bar Association was asked to consider a resolution in support of the legislation, and that resolution failed of passage.

There are no compelling policy reasons which would justify departing from the well-established rule denying deductions for self-insurance reserves. The availability of coverage is no longer a problem. The number of carriers writing architects and engineers liability insurance has increased since 1974–75, the peak of the underwriting crisis, and it is difficult to imagine that a design firm would be unable to obtain one or more quotes for coverage. In the current market, the more reasonable explanation for firms going bare—operating without insurance—is a conscious decision to risk an adverse judgment rather than pay the cost of insurance.

It is true that the cost of liability insurance, which we understand to be the principal concern of architects and engineers, increased in the early 1970's and peaked in 1974–75. These increases were the product of changes in the tort law, which led to a substantial increase in the size of court awards as well as an increase in the number of claims. As the size of claims increased and the trends changed, underwriters were forced to raise premiums.

As the introductory statement to S. 1081 pointed out, between 1969 and 1979 liability premiums paid by architects and engineers rose from $25 million to $175 million. During the same period, payments by insurance companies shot from an estimated $32 million to $235 million. These statistics show an increase in premiums to 700 percent and a corresponding increase in claims to 735 percent.

Our surveys of a number of underwriters in this market show that recent developments have been encouraging. Rates for professional liability have been stable for the past 4 years. The underwriting activities of a number of companies in this line have led to increased price competition. Design professionals and their brokers may now seek a number of alternative bids in order to obtain the lowest rate. Published statements of brokers and design professionals in their trade journals confirm our insurance surveys.

Jack McKee, staff director of the National Society of Professional Engineers' Private Engineers in Professional Practice, was quoted in the January 1980 issue of Building and Design Construction as saying, "Based on what we've seen in the past year, we have more reason for optimism than at any time in the last 11 years I have been with the National Society of Professional Engineers."

New approaches have been developed to deal with the underwriting problems created by high claims costs in this line. These techniques include drafting limitations of liability into design services contracts, creating captive insurance companies and the adoption of a retrospective rating plan in which, depending upon the firm's experience, an insured may either receive payment from the insurance company or be required to pay an additional premium.

However, design professionals err in their belief that a tax deduction for self-insurance of the deductible will provide a dramatic reduction of premium costs. The rates for professional liability coverage reflect a continuing problem of severity, meaning the size of claims, rather than the frequency, the number of claims. The most important factor determining the cost of this line of insurance has been the severity of claims. An increase in the size of the deductible will reduce premiums where frequency rather than severity is the determinant of the cost of the insurance.

There is a risk that the tax legislation that encourages self-insurance may leave injured parties without adequate guarantees of payments. S. 1081 fails to require that a design firm make regular contributions of an amount sufficient to fund projected claims. In the absence of such a requirement, it is possible that a pattern of irregular contributions could develop, similar to that which marked contributions to small pension plans before ERISA. A taxpayer could set aside amounts to shelter income during profitable years while omitting contributions altogether during the lean years.

Finally, it is important to remember that the increases in the insurance costs of which design professionals complain are the product of the changes in the liability system which have occurred over the past decade. Rather than seeking a solution to a liability problem by advocating a special tax deduction for single, narrow interest groups, the proponents of this legislation would be better advised to work with representatives of manufacturers, insurers, and other groups active in product liability legislation, in their current consideration of reforms of the liability system.

Senator PACKWOOD. Mr. Duvall.

STATEMENT OF J. SPRIGG DUVALL IV, PRESIDENT, VICTOR O. SCHINNERER & CO., INC., WASHINGTON, D.C.

Mr. DUVALL. Thank you, Mr. Chairman. I have submitted a written statement. I would prefer to respond to some of the objections that I have heard raised to the bill, in the interest of time.

Senator PACKWOOD. I think that would be a very wise use of your time, because the statement will be in the record in its entirety.

Mr. DUVALL. My firm has been involved as underwriting manager for professional liability insurance for architects and engineers for 25 years this coming February. It has been my entire business career, in fact. So we feel we have the data and the knowledge of the risk to speak as experts in this field.

I have heard today four, it seems to me, at least superficially, reasonable objections to the bill; however, I use the word "superficially" advisedly.

First of all, to answer your question, Senator, deductibles are mandatory in this type of coverage. There is no way for an architect or an engineer to buy commercial insurance to cover his deductible. There are minimum deductibles imposed of at least 25——

Senator PACKWOOD. What do you mean when you say "they are mandatory"?

Mr. DUVALL. No insurance company will insure.

Senator PACKWOOD. But not imposed by law, though. You are saying this is a matter of custom in the writing of the insurance.

Mr. DUVALL. That is correct. The smallest one-man firm must carry at least a $2,000 deductible. We have insureds whose deductibles are as high as a half a million. So that solution is not available, as a matter of choice, to the architect or to the engineer.

Treasury seemed to object for two principal reasons, the first being that this gave a special group the ability to invest pre-tax or tax-deductible dollars. Well, the fact is, many insurance programs for associations today do contain within themselves that same ability. The difference is that the insurance company is able to offer it to the insureds, partly as an inducement to participate, some form of investment opportunity with our tax-deductible dollars. So it doesn't seem to us to create that much of a difference in the way others are being treated.

The other Treasury objection dealt with the fact that it would seem to be of most benefit to the highest income professionals who have the least need for it. Well, the fact is, deductibles, as an underwriting requirement, are geared to the income of the insured. So the higher the income, the higher the deductible. There is really no choice on the insured's part in that matter, which in turn means that the higher the income, the greater the exposure to the out-of-pocket loss which this fund attempts to respond to.

Second, the larger the firm, the larger the income, the more frequent the claim against that firm that would have to be paid out of this so-called self-insurance fund. Therefore, that objection in fact has no validity in terms of the real world in which these professionals are practicing.

My colleague from the insurance industry had two objections, which I think should be answered. The first has to do with the question of frequency versus severity. She is quite correct. This type of plan is most effective and most useful where frequency is the problem. Referring again to our 25 years of experience and the fact that we have insured the majority of the risks over that period of time, and in some phases of the 25 years we have been the only insurer, I believe our data is probably the most accurate. Frequency is the problem for this particular class. There is no other profession in which the frequency of claim per 100 insureds even approaches half of the current rate of 44 claims per 100 insureds for architects and engineers. Even that dreaded class of insurance, the automobile driver, does not have a frequency of claim that approaches that of an architect or engineer. So it is a frequency problem and, therefore, it is most appropriate to solve the problem in this fashion.

The other objection, which is a more general one, that this is creating a special group with special treatment, has already been partly answered. I would like to expand on the difference between an architect and an engineer and other professionals and other businessmen.

We happen to also provide insurance for lawyers, for doctors, and for hospitals; so we have a working knowledge of their risks as opposed to the design professional. The doctor, as you have heard, has a limited number of potential claimants. He also has a limited peril, in that it is a bodily or death exposure that is relatively well understood and relatively simple to measure. It is a large one, but it is still relatively simple to measure. The lawyer or the accountant is dealing with an intangible type of financial loss. There is no property damage, there is no blood, there is no death. But, still, it is limited to a small number of potential claimants, and it is a relatively direct, measurable exposure.

The engineer, on the other hand, has the bodily injury and death exposure at least equal to, and as we now know from recent catastrophies, greater than a doctor's. They have the intangible financial loss exposure, because of loss of use of buildings. I refer you to the Hancock Building in Boston which could not be rented for over 4 years because of the problems in that structure, a very clear and intangible loss. And, finally, the property damage itself that can occur in a building for which the architects and engineers provide services. So it is a unique and a special group within our society, which, I believe, deserves some unique and special treatment.

Thank you very much for the opportunity to appear here this morning.

Senator PACKWOOD. Thank you very much.

Ms. Viehe-Naess, do I pronounce your name right?

Ms. VIEHE-NAESS. That's close.

Senator PACKWOOD. All right.

What is the tax status in the workers compensation field for those companies that self-insure in States that allow self-insurance?

Ms. VIEHE-NAESS. My understanding is that they would not ordinarily receive a deduction in the year in which amounts are set aside, only in the year in which amounts are paid out in claims.

Senator PACKWOOD. But then they would get the deduction. And do they get the deduction only to the amount of the claim, or what?

Ms. VIEHE-NAESS. Yes, in the amount paid out in the year in which the payment occurs.

Senator PACKWOOD. I am curious. If you would, comment on Mr. Duvall's statement that you cannot buy a policy without a deductible, and in some cases a rather high deductible.

Ms. VIEHE-NAESS. My understanding is that that statement would only be accurate. I have no personal experience in shopping for a policy, but that seems to be the practice in this particular line.

Senator PACKWOOD. So if that is the practice, why should these professions, at least, be denied the opportunity to self-insure for that part of it, if they chose to?

Ms. VIEHE-NAESS. We have a particular concern not only about the deduction in this area but about the general principle. We are concerned that once the wall is breached there will be no limits, as a practical matter.

Senator PACKWOOD. Now wait. You lost me there. What do you mean "if the wall is breached, there will be no limits"? If we write limits into the law, that is the limit.

Ms. VIEHE-NAESS. But there is going to be extreme pressure to continue and expand.

Senator PACKWOOD. Well, yes. But that is true of all laws at any time. What you are saying is, if they are only limited to what they are asking for in this bill, that wouldn't be too bad; but you think that is just the opening wedge.

Ms. VIEHE-NAESS. That is a principal concern.

Senator PACKWOOD. Dave.

Senator DURENBERGER. I wonder if Ms. Viehe-Naess would respond to the frequency-severity issue, once again, in light of what Mr. Duvall has said.

Ms. VIEHE-NAESS. My data is not consistent with his. What I have learned from actuaries is that severity is the principal problem.

Senator DURENBERGER. You don't question his bona fides?

Ms. VIEHE-NAESS. Absolutely not. I am sure he means well, and I am sure he has done his best, but our data is not consistent.

Senator DURENBERGER. All right.

I have one question that relates to not only what Mr. Duvall indicated in his written testimony. But lots of other surveys have shown that if the trust funds are established, it is likely that architects and engineers will raise, or the process will raise, the deductibles. And it seems to indicate they will also increase coverage. If somebody has a $1 million coverage, they might increase it to $5 million, or half a million will get raised to a million. Don't you think that that is in the public interest and should be encouraged by the establishment of these trust funds.

Ms. VIEHE-NAESS. The statements in their testimony that they would increase insurance coverage if they had the tax deduction are not consistent with other statements and some of the submissions from private consultants which show that this is a profession made up of small firms with severe cash flow problems. I don't think they could afford to increase their coverage.

They, themselves, have talked about the severe problems of cash flow and the fact that they are very sensitive to business cycles and to construction cycles.

Senator DURENBERGER. But, all other things being equal, the proposition is an accurate proposition, is it not?

Ms. VIEHE-NAESS. I think it would be optimistic to say they could increase their coverage, but there is no evidence that that is what would actually follow.

Senator DURENBERGER. Thank you.

Senator PACKWOOD. Thank you very much. It was a very informative presentation on both of your parts.

[The prepared statements of the previous panel follow:]

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TESTIMONY OF BRENDA R. VIEHE-NAESS
TAX COUNSEL
AMERICAN INSURANCE ASSOCIATION

ON S.1081, DESIGN LIABILITY
SUPPLEMENTAL PROTECTION ACT

BEFORE SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE

NOVEMBER 6, 1981

SUMMARY OF TESTIMONY ON S.1081 DESIGN LIABILITY SUPPLEMENTAL PROTECTION ACT

1. Professional liability tax-exempt trust fund bills and product liability trust fund bills were considered and rejected by the 95th Congress. A 10-year net operating loss carryback was adopted in their place as part of the Revenue Act of 1978. The reasons which led to the proposal's rejection in 1978 apply with equal force today, viz., a tax subsidy for self-insurance of a deductible is neither efficient nor appropriate; no regulatory supervision comparable to that of insurance companies exists to provide adequate safeguards for injured parties; and encouraging small businesses to self-insure through tax deductions and trusts is an unworkable concept.

2. Availability is no longer a problem. Design firms are now able to obtain bids from several different insurance carriers.

3. Rates in malpractice insurance for architects and engineers have stabilized. Major increases occured in 1974-75 as a result of a dramatic increase in the size of judgments, but they have been stable for the past four years. Underwriting competition in this highly specialized line has increased, and architects and engineers may now seek bids from competing insurance carriers to obtain the lowest rate.

4. The size of deductibles is not so large that it will jeopardize the financial stability of a professional firm.

5. A substantial increase of the deductible above current levels will not provide the dramatic reduction of premiums for liability insurance which architects and engineers are seeking. The rates for professional liability coverage reflect a continuing problem of severity (the size of claims) rather than frequency (the number of claims), and further increases in deductibles will have only a very limited effect upon claims incurred or rates.

6. The architectural and engineering professions are composed primarily of small firms. It is doubtful that a substantial portion of their member firms could take advantage of the deduction. Large businesses and professional firms can self-insure and are already doing so in architects' and engineers' professional liability and other lines without tax deductions. Small businesses cannot self-insure with or without tax deductions.

7. Increases in the cost of liability insurance of which design professionals complain are the product of changes in the tort law. These problems could be addressed more effectively through revision of the liability system than by providing a special tax deduction for a single group of professionals.

TESIMONY ON S.1081
DESIGN LIABILITY
SUPPLEMENTAL PROTECTION ACT

Mr. Chairman and Members of the Subcommittee:

I am Brenda R. Viehe-Naess, Tax Counsel of the American Insurance Association, a trade association representing 150 stock property-casualty insurance companies, which write multi-line coverage throughout the United States. Their combined premiums in 1980 represented more than one-third of the property and casualty insurance premiums in the United States, and their combined assets accounted for slightly less than one-third of the total assets of property-casualty insurers.

CONGRESS HAS CONSIDERED AND REJECTED EARLIER EFFORTS TO OBTAIN A TAX DEDUCTION FOR SELF-INSURANCE OF PRODUCT LIABILITY LOSSES.

The question whether to grant a deduction for amounts set aside for self-insurance of professional liability and product liability was considered at length by the 95th Congress, which saw a number of bills introduced in both the House and Senate. The proposal had been one of several recommendations for relief of a severe underwriting problem in product-liability insurance made by the Interagency Task Force on Product Liability, a study headed by the Department of Commerce. After further consideration, Commerce Secretary Juanita Kreps announced on July 20, 1978, that the Administration had decided not to endorse the proposal. The reasons for the Administration's rejection of the proposal were explained by Deputy Assistant Secretary for Tax Legislation Daniel I. Halperin before this subcommittee on August 28, 1978:

> 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 laws, 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 ... would be to provide a special 10-year net operating loss carryback ...

The 10-year loss carryback was adopted as part of the Revenue Act of 1978.

At the same time that this issue was before Congress, the American Bar Association was asked to consider a resolution in support of legislation which provided tax incentives for the creation of self-insurance trust funds for product liability losses. That resolution was disapproved by both the Section of Taxation and the Section on Insurance, Negligence, and Compensation Law.

THERE IS NO REASON TO DEPART FROM LONG-STANDING TAX POLICY DENYING A DEDUCTION FOR SELF-INSURANCE.

We believe that the considerations of tax and public policy which led to the rejection of the proposal in 1978 apply with equal force today and that they require that the legislation proposing a special deduction for architects and engineers be rejected as well.

It is a long-established principle of the tax law that amounts are not deductible under the accrual method of accounting until "all events" have occurred which establish the fact of the liability giving rise to the deduction, and the amount of the deduction can be determined with reasonable accuracy. Treas. Regs. §1.466-1(c)(1)(ii) and §1.461-1(a)(2). Reserves set aside for anticipated workman's compensation claims and other self-insurance have consistently been denied a deduction. Rev. Rul. 60-275, 1960-2 C.B. 43. Spring Canyon Coal Co. v. Comm'r, 43 F.2d 78 (10th Cir., 1930) cert. denied, 284 U.S. 654 (1931). Thriftimart, Inc. v. Comm'r, 59 T.C. 598. Rev. Rul. 80-191, 1980-29 I.R.B. 18. The fact that these funds are held by an independent trustee rather than the taxpayer has not altered the treatment of contributions. Spring Canyon Coal Co. v. Comm'r, ante. Payments to a wholly owned insurance subsidiary - a "captive" insurer - have also been disallowed where the court found that risk-sharing and risk-distribution did not exist. The Carnation Co. v. Comm'r, 71 T.C. No. 39 (1978). See also Rev. Rul. 77-316, 1977-2 C.B. 53.

There are no compelling policy reasons which would justify departing from the well-established rule denying deductions for self-insurance reserves. The availability of coverage is no longer a problem. The number of carriers writing architects and engineers professional liability insurance has increased since 1974-75, and it is difficult to imagine that a design firm would be unable to obtain one or more quotes for coverage. In the current market, the more reasonable explanation for firms "going bare" - operating without insurance - is a conscious decision to risk an adverse judgment rather than pay the cost of insurance.

It is true that the cost of liability insurance, which we understand to be the principle concern of architects and engineers, increased during the early 1970's and peaked in the underwriting crisis of 1974-75. These increases were the products of changes in the tort law which led to a substantial increase in the size of court awards as well as an increase in the number of claims. As the size of claims and the trend of claims changed, underwriters were forced to raise premiums to meet rising claims costs. Yet, because the increase in premiums is attributable to changes which occurred in tort law and in the pattern of judgments against architects and engineers, it is hard to accept the contention of supporters of this legislation made in past years that the premiums for malpractice insurance are unreasonable or "exorbitant."

In the introductory statement to S.1081, the statement was made that liability premiums paid by architects and engineers rose from $35 million in 1969 to $175 million last year. To complete the quote from the article which appeared in Building and Design Construction for January, 1980, "payments by insurance companies for building-related casualty claims, including property damage (which includes remedial work) and bodily injury, have shot from an estimated $32 million in 1969 to $235 million last year." If these statistics are compared, they show an increase in premiums of 700% and a corresponding increase in claims of 735%.

Our surveys of a number of underwriters in this market show that recent developments have been encouraging. Rates for professional liability have been stable for the past four years, and the underwriting activities of a number of companies in this highly specialized line have led to increased price competition among insurers. Design professionals and their brokers may now seek a number of alternative bids in order to obtain the lowest rate. Published statements of brokers and design professionals in trade journals confirm insurance surveys showing increased competition in rates in this line. A January, 1980 article in Building and Design Construction entitled "Competition Forces Insurors to Ease Rate Hikes" stated:

> If a single word can describe the current state of the liability market for architects, engineers and contractors, that word is "better" ...
>
> Both brokers and buyers agree that the A/E professional liability insurance market is now quite competitive. ...
>
> "Based on what we've seen in the past year, we have more reason for optimism than at any time in the 11 years I've been with the National Society of Professional Engineers," said Jack McKee, staff director of NSPE's Private Engineers in Professional Practice section, about the current professional liability insurance picture. (pp. 61 and 62)

New approaches have been developed in the past five years to deal with the underwriting problems created by high claims costs in this line. These techniques include drafting limitations of liability into design services contracts to set a maximum for damages which could be sought from the firm; the creation of captive insurance companies similar to those created by physicians and attorneys (See "How Firms Ease Liability Insurance Costs," Building and Design Construction, Dec., 1978, p. 58); and the adoption of a restrospective rating plan in which, depending upon the firm's experience, an insured may either receive payment from the insurance company or be required to pay an additional premium (See "Competition Forces Insurers to Ease Rate Hikes," Building and Design Construction, January, 1980, p. 61).

A TAX DEDUCTION FOR SELF-INSURANCE OF A DEDUCTIBLE WILL NOT PROVIDE A DRAMATIC REDUCTION OF PREMIUM COSTS.

If what proponents of the legislation intend is a substantial increase in the amount of the deductible over those currently in effect in order to reduce premiums, they may be operating under a misconception. Self-insurance of a substantially increased deductible will not provide the dramatic reduction of premiums for liability insurance which architects and engineers are seeking.

The rates for professional liability coverage reflect a continuing problem of severity (the size of claims) rather than frequency (the number of claims), and the most important factor determining the cost of this line of insurance has been the severity of claims. An increase in the size of the deductible will reduce premiums where frequency rather than severity is the determinant of the cost of insurance, but increasing the size of the deductible will have only a nominal impact upon total claims, and, therefore, will not reduce premiums substantially in lines like professional liability where severity is the principal determinant of rates.

TAX LEGISLATION ENCOURAGING SELF-INSURANCE MAY LEAVE INJURED PARTIES WITHOUT ADEQUATE GUARANTEES OF PAYMENTS.

If the provisions of S.1081 are subjected to critical review, there appear to be certain problems with the proposal which bring into question its effectiveness. The maximum deductions of $100,000 or 5% of gross receipts established for taxpayers by S.1081 having a severe professional liability problem seem to be determined primarily by administrative considerations of ease of computation. They bear no relationship whatsoever to the projected level of a firm's professional liability claims. The bill also fails to require that a design firm make regular contributions of an amount sufficient to fund projected claims. In the absence of such a requirement, it is possible that a pattern of irregular contributions could develop similar to that which marked contributions to small pension plans of closely held corporations before ERISA -- a taxpayer could set aside amounts to shelter income during highly profitable years while omitting contributions altogether during lean years. Granting a tax deduction for plans which lack adequate funding requirements and adequate safeguards to ensure that amounts will be available to injured parties seems inconsistent with the Congressional policy which established rigorous standards for pension trusts as a _quid pro quo_ for the deduction of contributions.

TAX BENEFITS MAY FLOW PRIMARILY TO A SMALL NUMBER OF LARGE FIRMS.

Finally, we concur with members of the Administration and the Congress who concluded, after a thorough review of the Interagency Task Force's proposal for tax incentives for self-insurance of product and professional liability, that encouraging small and medium sized businesses to self-insure was an unworkable concept. Small businesses lack the claims handling facilities provided routinely by insurance coverage and, in the hope of avoiding costly legal fees, they may defer seeking legal counsel as quickly as they would under an insured program, thereby exacerbating problems of settling a substantial claim. In fact, surveys made during prior consideration of the tax-exempt trust fund proposal showed that few small businesses were interested in being self-insured against product liability risks. A "Survey Report on Product Liability" published by the National Federation of Independent Business in January, 1977, found that 42.8 percent of small businesses responding could not establish a self-insurance fund. Another 24.8 reported that they could do so, but only with difficulty. 5.9 percent replied that a fund was readily possible, while 8 percent had already established a self-insurance fund. The NFIB figures represent such a marked contrast to the survey quoted in Senator Mathias' introductory statement showing that two-thirds of design firms would establish tax-exempt trusts that we cannot help but ask if there is a certain element of wishful thinking reflected in respondents' answers.

In the case of architects and engineers, it is hard to believe that utilization of the deduction for self-insurance reserves would be much more widespread. The design professions are composed largely of small firms whose cash flow is highly sensitive to the fluctuations of the economy. According to a 1977 survey by the American Institute of Architects, 79% of their member firms had ten or fewer employees, and 94% had twenty-five or fewer.* It appears that

*Source: American Institute of Architects Memo, No. 576, August 20, 1979.

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Finally, we concur with members of the Administration and the Congress who concluded, after a thorough review of the Interagency Task Force's proposal for tax incentives for self-insurance of product and professional liability, that encouraging small and medium sized businesses to self-insure was an unworkable concept. Small businesses lack the claims handling facilities provided routinely by insurance coverage and, in the hope of avoiding costly legal fees, they may defer seeking legal counsel as quickly as they would under an insured program, thereby exacerbating problems of settling a substantial claim. In fact, surveys made during prior consideration of the tax-exempt trust fund proposal showed that few small businesses were interested in being self-insured against product liability risks. A "Survey Report on Product Liability" published by the National Federation of Independent Business in January, 1977, found that 42.8 percent of small businesses responding could not establish a self-insurance fund. Another 24.8 reported that they could do so, but only with difficulty. 5.9 percent replied that a fund was readily possible, while 8 percent had already established a self-insurance fund. The NFIB figures represent such a marked contrast to the survey quoted in Senator Mathias' introductory statement showing that two-thirds of design firms would establish tax-exempt trusts that we cannot help but ask if there is a certain element of wishful thinking reflected in respondents' answers.

In the case of architects and engineers, it is hard to believe that utilization of the deduction for self-insurance reserves would be so widespread. The design professions are composed largely of small firms whose cash flow is highly sensitive to the fluctuations of the economy. According to a 1977 survey by the American Institute of Architects, 79% of their member firms had ten or fewer employees, and 94% had twenty-five or fewer.* An ACEC 1979-80 profile showed that 75% of its members had fewer than twenty employees.** It appears that

*Source: American Institute of Architects Memo, No. 576, August 20, 1979.
**Source: Deloitte, Haskins & Sells Study for AIA & ACEC, July 30, 1980.

utilization of tax-exempt trust funds would be concentrated among those few firms in the engineering or architectural professions large enough to set aside reserves and that the benefits of any deduction would not be distributed broadly among firms throughout the profession.

INCREASES IN PREMIUM COSTS ARE ATTRIBUTABLE TO CHANGES IN THE TORT LAW WHICH SHOULD BE ADDRESSED AS PART OF THE RECONSIDERATION OF THE LIABILITY SYSTEM NOW UNDERWAY.

The increases in insurance costs of which design professionals complain are the product of changes in the liability system which have occurred over the past decade. Rather than seeking a solution to a liability problem by advocating a special tax deduction for a single, narrow interest group, the proponents of this legislation would be better advised to work with representatives of manufacturers, insurers, and other groups which participated in the consideration of the product liability trust fund legislation in the mid-seventies in their consideration of reforms of the liability system. We realize that revision of the product liability system is a complex and arduous undertaking, but we believe that this route offers real solutions to the problems created by product and professional liability insurance, solutions which are more effective than providing a tax advantage to a special interest group.

CONCLUSION

In summary, we believe that the additional tax deductions already provided architects and engineers by the Congress' adoption of a ten-year net operating loss carryback in 1978 provide sufficient relief and that no further tax subsidy can be justified. Liability insurance is now widely available, and rates have been stable for the past three years. By obtaining bids from a number of carriers, architects and engineers should be able to take advantage of the growing competition among underwriters. Finally, we believe that the solution proposed by S.1081 - a tax subsidy for self-insurance of the deductible - is ineffective. The use of increased deductibles will not provide the dramatic reduction of premiums architects and engineers are seeking where rates reflect problems of severity rather than frequency. The only effective way to reduce unreasonable professional liability claims is to convince state legislatures to reform the tort laws which have created the problems of the liability system.

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STATEMENT OF J. SPRIGG DUVALL, PRESIDENT
VICTOR O. SCHINNERER AND COMPANY, INC.
BEFORE THE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT GENERALLY
OF THE
COMMITTEE ON FINANCE,
UNITED STATES SENATE
S - 1081
DESIGN LIABILITY PROTECTION ACT OF 1981

Victor O. Schinnerer & Co., Inc.
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November 6, 1981
Washington, D. C.

Victor O. Schinnerer & Company Inc

S. 1081

SUMMARY OF TESTIMONY

J. SPRIGG DUVALL, PRESIDENT

VICTOR O. SCHINNERER & COMPANY, INC.

WASHINGTON, D.C.

November 6, 1981

I represent the largest insurer of professional liability for architects and engineers. We have worked in close cooperation with The American Institute of Architects and the National Society of Professional Engineers for 25 consecutive years.

The number of claims made against architects and engineers has increased dramatically, the claim ratio in 1980 being 44.8 per 100 firms vs. 36.3 in 1978. (A 23% increase!)

Engineers and architects are unique among professionals in being subject to three types of exposures; and a single claim can involve any combination or all three categories:

personal injury
damage to tangible property
intangible financial losses

It is this multiplicity of perils which distinguishes the design professional (in the liability context) from all other professionals, such as doctors, lawyers, accountants, etc. who normally are liable only for one of the above exposures. And this is the very reason why design professionals' liablity is such a problem and deserves the special consideration here sought.

Cost of professional liability insurance for these professions can range from about 2% to as much as 10% of the firm's gross billings. These policies are written on a "claims made" basis; i.e., the insurance must be in force when the claim is made, regardless of when the professional services were performed.

Every policy contains a deductible amount which must be paid by the insured before the insurance company becomes liable for payment.

The proposed tax deduction for amounts paid into a reserve for service liability losses represents fair and equitable tax treatment of a bona fide business expense of the design professional. The public will benefit in that the design professionals will be more likely to have sufficient assets to pay their deductibles, and also the retired professionals will have accumulated funds to meet their own obligations.

The public is entitled to and expects that design professionals will have sufficient resources to meet their obligations. This proposed legislation will help bring that expectation to reality.

Victor O. Schinnerer & Company Inc

STATEMENT OF J. SPRIGG DUVALL
IN SUPPORT OF S. 1081
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
GENERALLY, COMMITTEE ON FINANCE, UNITED STATES SENATE
November 6, 1981

I am J. Sprigg Duvall, president of Victor O. Schinnerer & Company, Inc., the program administrator for the professional liability insurance programs commended for architects and engineers and other design professionals by the American Institute of Architects, and the National Society of Professional Engineers. Our firm has served as the professional liability insurance counsellor to AIA and NSPE since 1957, and we presently are the principal underwriting manager in the United States for professional liability insurance for architects and engineers. At this time, we insure more than 6,000 design professional firms.

We are grateful for this opportunity to testify in favor of S.1081, Design Liability Supplemental Protection Act of 1981. With me, today, is Paul L. Genecki, a Senior Vice President of our firm, and J. Winfield Rankin, Director of our Office for Professional Liability Research.

Other witnesses will address the specific provisions of the supplemental protection program for which this Bill provides a tax deduction within certain limits. Rather than duplicate their testimony on these matters, I would like to discuss the professional liability insurance aspects of the problem to which this proposed tax measure is directed.

Since the end of World War II, all professions in the United States have seen a substantial increase in the claims made against their members for professional liability or malpractice. Professional Liability claims have become a serious professional and financial problem for all professions, irrespective of whether legal liability ultimately is imposed.

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Within the professional liability arena, there are three categories of exposure, or types of claims, that confront professionals:

1. Personal injury including bodily injury and death.

2. Damage to tangible property.

3. Intangible financial losses, such as loss of property rental income, loss of mortgage commitments, and losses occasioned by increases in interest rates attributable to delays.

For hospitals, doctors, dentists and other health care providers, the professional liability exposure is almost entirely bodily injury or death and usually involves but a single claimant. Lawyers and accountants have a professional liability exposure that usually encompasses intangible financial loss and, with the exception of SEC related matters, involves a sole claimant. Architects and engineers, however, regularly are confronted with professional liability claims involving multiple parties and arising out of any of these categories of exposure.

Claims against design professionals alleging losses in all three categories are not atypical. This is the major distinction in the professional liability exposure facing architects and engineers as contrasted to all other classes of professionals. Indeed, it is a unique and very complex exposure. In fact, in claims against design professionals, the cost of the investigation and defense can equal or exceed the original design cost of a project.

To date, the professional liability problem for architects and engineers has been especially complex because of the wide variety of sources from which claims can arise. There are many influences which affect the design professional's daily practice in this regard. Professional liability claims against architects and engineers can result from alleged negligence in the project design or in the preparation of the drawings and specifications. They can arise from services performed during the construction phase while acting as the owner's agent; or from allegedly improper specifications

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for new materials and products, or from specifications for traditional products used in a new way without adequate testing; or from the increasing scope of government regulations such as building codes or standards, environmental laws, and regulations related to occupational safety; or from the constraints imposed by time and money in an era of high inflation and interest rates which result in demands to complete projects more quickly than normal; or, finally, from the changing attitudes of the courts and society in regard to the accountability of professionals for the consequences of their acts.

One way the insurance industry measures this professional liability problem is to look at the frequency of claims against architects and engineers. Measuring that frequency in terms of numbers of claims per 100 architect or engineer firms per year, our records indicate that the frequency in 1960 was 12.5 claims per 100 firms insured in the program which we manage. By 1978, that frequency rate rose to 36.3 claims per 100 insured firms, and to 44.8 in 1980! Put another way, the "risk" probability is that close to one-half of all design professionals' firms will experience a professional liability claim in 1981. A majority of claims are disposed of without the need for any indemnity payment by the insurance companies, but the services of defense attorneys and expert witnesses, and the time spent by a design professional to establish a successful defense, can be extremely costly. This cost is usually borne by the architect or engineer under his insurance policy deductible or out of pocket. As can be seen, this overwhelming increase in claim frequency is a particularly acute problem for design professionals.

The other major parameter used to measure professional liability is the severity of claims. This quantifies the cost of claims. (Frequency quantifies the number of claims.) Starting at the same point used above to measure claim frequency, 1960, the value of an average claim was $5,481. This amount is derived by dividing the total incurred loss for the claims by the total number of paid claims. This amount is in excess of the insureds' deductibles and reflects only the insurance company's claim experience in the first $250,000 layer of insurance. By 1978, the

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average claim had reached $43,659. When all of the 1980's claims have been reported and resolved, the actuaries tell us that that average will exceed $46,000.

You already have heard from other witnesses that the cost of professional liability insurance truly is a burden to architects and engineers. The cost of professional liability insurance to an architect or engineer, in addition to their obligation to pay substantial deductibles, is somewhere in the range of 2% to more than 10% of gross billings. The cost of professional liability insurance, after personnel or salary costs, is the highest expense item for many architects or engineers.

It is important to understand how architects' and engineers' professional liability insurance policies are written to see the benefits inherent in S. 1081. These insurance policies are written on a "claims-made" basis -- i.e., the insurance must be in force when the claim is made, irrespective of when the professional services were performed. And, these policies contain substantial deductibles on a per claim basis, which apply to both indemnity payments made to a claimant and to the investigative and legal costs incurred in defending against the claim. In many cases, an architect or engineer who is absolved of liability must pay thousands of dollars just to establish the successful defense. (In some cases, insureds elect to pay higher premiums to reduce or eliminate the deductible for certain types of claims. However, the underlying problem with the expense associated with professional liability insurance remains.) Under the insurance program for which we serve as the underwriting manager, the current minimum per claim deductible is $2,000. The most commonly carried deductibles are in the $5,000 to $10,000 range. Rather obviously, any firm that has even a single claim is faced with a substantial financial exposure irrespective of insurance coverage.

The proposed tax deductions for amounts paid into a reserve for service liability losses represents fair and equitable tax treatment of what, by any reasonable standard, is a bona fide business expense of the design professional. In the ordinary conduct of a firm's business, we believe a responsible architect or engineer would set aside funds, not only for his own protection, but also for the ultimate protection of the public, for potential professional liability claims. Insurance premium costs

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are, of course, deductible at present. Monies contributed to a reserve for similar purposes should, in all fairness, be accorded similar tax treatment.

No real distinction should be made between these two forms of financial protection and, therefore, there should be no disparate treatment for tax purposes.

In our opinion, there are three benefits to be derived from S. 1081:

1. As the nature of the construction industry -- and the architects' and engineers' services -- is so extraordinarily cyclical, a firm with a good profit picture today can be unable to meet its obligations in another year. This proposed legislation will provide an orderly mechanism to accumulate funds in good times in order to pay deductibles whenever necessary. This will be a benefit to the public as well as the professionals.

2. It would allow architects and engineers to more easily afford to pay multiple deductibles in those years in which they might be faced with more than one claim.

3. After ceasing to practice, it would allow design professionals to pay the costs associated with claims, with funds accumulated during years of active practice, thus alleviating the burden created by the necessity to continue to pay professional liability insurance premiums as a measure of postpractice protection. This burden thus would be alleviated without affecting recovery by consumers in situations involving valid claims.

We believe that S. 1081 will enable more firms to become better equipped to deal with these financial realities. It will not produce an immediate or dramatic reduction in professional liability insurance premiums. In fact, the short term effect would be to increase total professional liability related costs as design professionals make contributions to trusts while continuing to pay for insurance at current rate levels.

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But, with a tax qualified reserve, architects and engineers will be able, over time, to increase their deductibles on commercially purchased insurance, and thus eventually will benefit from a related decrease in premium costs. The reserve that could be established because of S. 1081 will alleviate the financial hardship that can arise whether a firm has the misfortune to incur a single claim or multiple claims within an abbreviated time span.

In all of this, as well, the public has a vital interest. There can be little doubt that members of the public as well as professionals' clients are directly benefited by architects and engineers having financial resources in the event of a professional liability claim. If a person is injured or damaged by a design professional's negligence, there can be no meaningful recovery in the absence of insurance or personal assets. If a professional has chosen not to purchase professional liability insurance because of the expense, or has insufficient resources to pay the deductible, the injured party rather than the professional will suffer the financial burden. We see S 1081 as a solution to this very real problem. The tax qualified reserve should encourage design professionals to become better equipped to deal with the unfortunate consequences of professional liability.

We strongly urge that S. 1081 be given favorable consideration, and we thank you for this opportunity to present our views.

Senator PACKWOOD. We will conclude today with S. 1764. And we have a panel consisting of Brewster Ives, Ralph Colin, and Frank Karelsen.

All right, Mr. Ives, go right ahead.

Mr. KARELSEN. Well, my name is Frank Karelsen III. I am chairman of the New York State Bar Committee on Co-ops and Condominiums and chairman of Mayor Koch's advisory committee on housing. I will sort of act as chairman of this panel. I would like to add, as a starter, Mr. Martin Cowan, who is an attorney and who is chairman of the real estate tax committee of the tax section of the ABA. However, Mr. Cowan is not representing to ABA here today.

Senator PACKWOOD. Mr. Cowan, is it?

Mr. COWAN. Yes, sir.

I have admonished all members of the panel, including myself, to be brief, and have pointed out to them that you have announced that their statements are submitted. So, without further ado, I will call on the gentleman on my right, Brewster Ives, who will give our first testimony.

Senator PACKWOOD. Go right ahead, Mr. Ives.

STATEMENT OF BREWSTER IVES, PRESIDENT, TENANT-OWNED APARTMENT ASSOCIATION, INC., NEW YORK, N.Y.

Mr. IVES. I am Chairman of the Board of Directors of Douglas Elliman-Gibbons & Ives and have specialized in the sale and promotion as well as the management of cooperative apartment houses in New York City for over 50 years. We handle about 200 of the larger buildings but also a great many smaller ones in rural Brooklyn, for example, where the price level is at an extraordinarily low point.

I have also served as a director of the Tenant-Owned Apartment Association for over 50 years, and I recall 40 years ago when section 216 was adopted by the Congress. We accepted the limitation of 20 percent of the income of cooperative apartments derived from individual proprietor lessees as one that we were perfectly willing to face, because we didn't consider that to be a burden at that time. We were so imbued with the idea that we wanted equal treatment of the law with private homeowners and condominium owners—condominium owners hadn't been in the marketplace at that stage, but with private homeowners.

There appears to be no rational reason for the 80-20 provision. We feel that it has been extremely burdensome for cooperatives for the simple reason that they are now prevented from accepting commercial lease rentals at anything more than that level. There are countless incidents where buildings have suffered, giving up income that could be taxable income to the Government merely because of that straightjacket.

I particularly want to refer to the effects of all this on new construction, and I am sure we are all aware of the critical need for more construction. In New York it has been curtailed to the point where we have an extreme shortage. Those jobs that are going ahead and that have been moving ahead in the last several years are all in the direction of condominium ownership rather than cooperative ownership, and it is clearly because we are not limited to individuals as stockholder lessees; we can accept corporations, family holding companies, partnerships, legations, Government agencies, et cetera. And with that larger market, the condominiums have survived and have pushed cooperatives into the background. Cooperatives have virtually stopped, as far as new construction is concerned. And it all goes back to this 80-20 limitation.

The objections that have been made by the Treasury Department can better be answered by my compatriots here, so I will terminate my testimony on that point.

Thank you.

Senator PACKWOOD. Let me ask you a question, before you move on. In New York City, itself, roughly what proportion of people would live in co-ops and condominiums and then in regular tenants paying rent?

Mr. KARELSEN. Could I answer that question, Mr. Ives? Because I just got these figures from the city, and these are figures as of 1980.

Senator PACKWOOD. All right.

Mr. KARELSEN. According to the city figures, there are 83,000 units that are cooperatives; 10,000 that are condominiums; and 2 million rental units.

Senator PACKWOOD. Are cooperatives that common outside of New York?

Mr. KARELSEN. They are becoming much more so, sir, which I will get to in my testimony.

Senator PACKWOOD. All right. Go right ahead.

Mr. KARELSEN. Ralph?

STATEMENT OF RALPH COLIN, PRESIDENT, 33 EAST 70TH STREET CORP., NEW YORK, N.Y.

Mr. COLIN. Well, I would just add to what Mr. Ives said, Mr. Chairman, on my experience as the president of a cooperative tenant association. And I have been president since 1975.

We are in fact subsidizing a number of commercial tenants because of the fact that adjacent properties which are not in cooperative buildings are demanding much, much higher rents while the cooperative apartment house is primarily a residential building. In many cases, and in our particular case, it was built many, many years before it became cooperative, and it was built as a combined commercial-residential operation. We, therefore, have to have, in effect, a commercial business in our building. We feel we are being severely limited as to what we can do with the building because of the fact that we can only take in 20 percent of our income from the commercial tenants.

The argument that the Treasury gave somewhat baffles me, because it seems to me that if we are allowed to increase the portion of our income that comes from commercial tenants, it also increases the amount of revenue that they take in in taxes. So, it seems to me, the reduction of the 80-20 restriction to 50-50 benefits not only the people who live there but also the Government, in effect, by increasing its tax rolls.

Thank you, sir.

STATEMENT OF FRANK KARELSEN, ESQ., CHAIRMAN, SUBCOMMITTEE ON CONDOMINIUMS AND COOPERATIVES, REAL PROPERTY SECTION, NEW YORK BAR ASSOCIATION, NEW YORK, N.Y., ACCOMPANIED BY MR. MARTIN COWAN.

Mr. KARELSEN. Mr. Chairman, what is interesting about this hearing today is, we are not discussing, really, a tax problem; we are discussing a housing problem.

I have talked throughout this country about co-ops and condominiums and, in answer to your earlier question, I was quite surprised 1½ years ago in California to learn how many people wanted to have cooperatives. There are various financial advantages, et cetera, which I won't go into. But their point here is that, should there be a real difference between the treatment of a condominium complex and a cooperative complex, when they both will end up paying the same kind of taxes?

In reality, the Government, by the 80-20 rule, is not only foisting inequality among co-ops and condominiums but, more importantly, is depriving itself of income not only from the commercial unit itself but from the cooperative corporation which would have to pay a tax on the income it receives.

The kind of structure that we are talking about, whether it is a co-op or a condominium or commercial, or what not, would be governed in New York City by our zoning law and in other areas by local applicable housing laws.

So what this law does is affect the housing stock, and we see no reason to differentiate on this matter between co-ops and condominiums. We submitted a lengthy report of the State bar association, and I must say I am very pleased that the Treasury Department indicated this morning, in its testimony and in the written testimony you have, that they would be glad to sit down and work out some of the inequities that are contained in section 216 other than the 80-20 rule. And this is something I think we would be more than willing to do, because we have been working on this matter for over 5 years.

Finally, before I turn this over to Mr. Cowan, who will analyze the tax aspects, I cannot understand where, in the report that was submitted for today's hearings with respect to this bill, it says "revenue effect." "It is anticipated that this bill would reduce budget receipts by less than $5 million annually." Well, I agree it would increase budget receipts by more than any figure. So I don't know what the $5 million is based on.

Without further ado, Martin Cowan, who has with him some of the law journals that he has written on this subject.

Senator PACKWOOD. That $5 million is a standard figure we often use where we think there will be no revenue loss at all. We get very callous here on the Budget Committee. Anything less than $50 million is an asterisk. One of the ways you learn to get some of your programs passed is to have them cost less than $50 million, and they will be rounded down rather than up, and, therefore, it costs the Government nothing.

Mr. KARELSEN. I see, sir. Well, with New York City, $5 million means an awful lot.

Senator PACKWOOD. Go right ahead, Mr. Cowan.

STATEMENT OF MARTIN COWAN, CHAIRMAN OF THE REAL ESTATE TAX COMMITTEE OF THE TAX SECTION OF THE AMERICAN BAR ASSOCIATION

Mr. COWAN. At the beginning, I wish to repeat the disclaimer that I am in any way representing the American Bar Association or its tax section today, but I appear, along with Mr. Karelson, on behalf of the real property section of the New York State Bar Association. However, I believe that I may fairly call the committee's attention to the fact that the tax section of the ABA has on record a recommendation that the 80-percent restriction in section 216 be liberalized. That recommendation, No. 1972-3, is not identical in terms to the present bill, but is largely consistent with it.

I did not have the opportunity to review Secretary Chapoton's comments in advance and, therefore, I have not been able to prepare a detailed reply, but I would like to offer some brief general comments on the problems he raised.

We believe that those problems are largely insubstantial. They relate exclusively to the so-called commercial or outside income and, in Secretary Chapoton's own words, the "dual nature" of cooperative housing corporations.

As noted many times elsewhere, including numerous congressional committee reports, and as Secretary Chapoton himself stated several times today, the principle of section 216 is to treat the residential owner in a cooperative housing corporation as though he owned his unit individually. To the extent the cooperative housing corporation derives a profit from sources other than its tenant-stockholders, a strict application of this principle would require that the outside profit be taxed directly to the shareholders on a conduit basis, at tax brackets ranging from 0 percent to 50 percent.

Historically, this has not been done. Such profit is taxed, instead, at the corporate level at the usual corporate rates, which currently range from 17 percent to 46 percent (with a slight reduction of the lower end scheduled for the near future). In some cases, this results in a modest reduction in the tax collected, but, probably, in at least as many other cases, it results in an increase.

It is misleading to suggest, then, that this outside income is untaxed or undertaxed. It is properly taxed, once. Section 216 reflects the longstanding policy not to tax the owners a second time merely because they have used the corporate form.

Under section 216, that single tax is assessed at the corporate level, not the individual level. Overall, it does not appear that the difference in tax rates between individuals and corporations combined with the fact of corporate rather than individual taxation generates any meaningful increase or decrease in net tax revenues to the Treasury, or otherwise creates unreasonable results. Certainly, as an administrative matter, it is far easier to calculate and collect the tax at the corporate level.

Congress has focused on this very issue at least twice in a situation which is analogous; both cases involved condominium associations. In section 528(c)(1)(D), enacted in 1976, Congress repudiated an inference that the commercial income of homeowners' associations should be considered a dividend to the owners, even though that income was used in part to pay for the operation and maintenance of their personal dwellings. Instead, Congress provided that

that income is to be taxed solely at the association level. Moreover, in lieu of the graduated corporate rates, Congress amended section 528(b) last year, to provide that the associations' tax rate should be a flat 30 percent. This results in substantial administrative simplification and, by the very nature of its action in this context, Congress has determined that this does not produce an improper result. In its report on the 1980 amendment (S. Rept. No. 1036, 96th Cong. 2d Sess.), this committee stated:

> * * * the taxable income of a homeowners association should not be subject to tax at higher rates than the rates which would normally apply to such income if it were taxable to the members of the association. However, it would be too complicated to require a passthrough of ratable portions of an association's income to its members. Consequently, the committee believes that it is appropriate to tax the income of homeowners associations at a flat rate of 30 percent, which may reasonably appropriate the average marginal income tax rate of the members of these associations.

We are taking no position at this time on whether the same 30-percent flat rate should apply under section 216 also. It is not necessary to consider that particular detail today. In either event, it is clear that Congress has concluded that in this context such income is properly taxed only at the corporate level.

No one has ever suggested a logical reason to tax condominium unit owners in manner different from tenant-shareholders in cooperative housing associations. Hence, the congressional policy to tax the commercial income of condominiums solely at the corporate level should be just as applicable for cooperative housing corporations. In fact, when section 528 was first proposed, the bill as passed by the House of Representatives would have applied to cooperative housing corporations as well. Subsequently, the bill was amended to exclude cooperative housing corporations, in large part because there was not sufficient time during the legislative process that year to resolve certain technical differences between proposed section 528 and the rules in section 216. This legislative history further demonstrates that the congressional policy with respect to the treatment of dividends is no different from cooperative housing corporations than for condominiums.

Secretary Chapoton's statement regards the dual nature of cooperative housing corporations as unfortunate. We respectfully disagree. The use of the corporate format, rather than, say, the condominium format, should be a function of strictly nontax considerations, such as local zoning laws and mortgage financing. The object of section 216 is—and always has been—to eliminate this technicality as a factor in the taxation of homeowners.

With this understanding, the dividend question and other aspects of the dual nature of cooperative housing corporations loses substance. For example, the section 1034 issued raised by the Secretary is not very significant, because commercial properties owned outside the corporate structure could also be exchanged tax free under other sections of the code, such as section 1031. While these other sections contain some variations in the conditions for such exchanges, the basic policies of these sections are not in conflict with the result under section 216.

The provisions of section 121(d)(5) probably should already be construed to avoid the problem raised by the Secretary under that section. Certainly, the language of the statute gives Treasury ample authority to limit the benefits of section 121 to the portion of the stock reflecting the value of the tenant-stockholder's dwelling unit. In fact, authority exists for applying the same limitation under section 1034. See, e.g., Reg. § 1.1034-1(c)(3)(ii); *Bogley* 263 F. 2d 746 (4th Cir. 1959); *F. R. Campbell Estate*, T.C. Memo., 1964-83.

The Secretary's unfavorable comparison to condominium associations under section 528 is also incorrect, because section 528 is elective and very few condominiums elect to come within section 528—I would guess probably less than 1 percent. Hence, condominiums generally do not need to observe the section 528 limitations. Certainly, those which cannot satisfy those limitations do not elect section 528. Cooperative housing corporations do not have this option.

We recall that Treasury also opposed the original enactment of section 216 and its predecessors, back in 1928 when a bill passed the House of Representatives, and in 1942, when the predecessor of section 216 first became law. In both cases, the Treasury's opposition was based in part on its concern over this corporate noncorporate duality of cooperative housing corporations. Now, as then, it is difficult to understand.

The taxation of outside income to the corporation, rather than to the tenant-shareholder, is not a justification for opposing simplification and otherwise needed reform of section 216.

I repeat Mr. Karelsen's statement of appreciation for Secretary Chapoton's statement recognizing that there are problems under section 216, and offering to work with this committee and its staff to produce appropriate solutions. While the present bill does not go as far as the proposal of the New York State Bar Association's real property section, we believe it is a step in the right direction and urge that it be passed, at least as an interim step on the way toward overall simplification and reform of section 216.

Thank you.

Senator PACKWOOD. I appreciate the history. I am not surprised that the Treasury did. Normally on these Fridays when we hold these hearings, with very minor exceptions, Treasury is opposed to almost all of the bills. They were in favor of one this morning, as you heard earlier. And we give their objections due note. But I think this committee will decide on the basis of what we think are the merits, regardless of the Treasury's view.

I appreciate this panel this morning very much. I don't think I have had a panel before that had such a good cross section of depth. I doubt if there is any issue in this field that one of the four of you, either by experience in the practice of the tax law or by the experience in the management of property, could not answer. It has been very, very helpful. Thank you very much.

Mr. KARELSEN. Thank you, Mr. Chairman.

[Whereupon, at 11:15 a.m., the hearing was adjourned.]

[The prepared statements of the previous panel follow:]

TESTIMONY OF FRANK E. KARELSEN, III, ESQ.

AT A HEARING OF THE

SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT

OF THE

SENATE COMMITTEE ON FINANCE

November 6, 1981

My name is Frank E. Karelsen, III, Esq. I am a partner in the law firm of Kurzman, Karelsen & Frank, 230 Park Avenue, New York, New York. I have specialized for nearly thirty years in the field of real estate, with emphasis particularly on cooperatives and condominiums. I am currently Chairman of the New York State Bar Association Subcommittee on Co-ops and Condominiums, a member of the New York City Bar Association Committee on Housing and Urban Development, and the American Bar Association, Tax Section's Committee on Real Estate Tax Problems. In addition, I am Chairman of the Citizens Advisory Committee to the Department of Housing Preservation and Development of the City of New York.

I welcome this opportunity to discuss with you the problems of Section 216 of the Internal Revenue Code. Before going into the specifics of the amendments being requested here today, I would like to state that, for the past fifteen years I have lectured on cooperatives and condominiums throughout this country, literally from New York to California, and I have found that the most efficient way to combat urban housing blight is through the vehicle of cooperatives and condominiums. Pride of ownership goes a long way toward maintaining and refurbishing our housing stock.

What we request today will help improve housing conditions in the United States. To a slight extent, it should also increase the revenues of Federal, State and local government. In other words, the amendments that we request will not cost governmental subdivisions money, but will probably increase tax revenues and, in the long run, reduce the need for housing subsidies.

Simply stated, how does this come about? The problem is that, in order to qualify under Section 216 of the Internal Revenue Code, a cooperative housing corporation is limited to receiving 20% of its income from sources other than its tenant-shareholders. This, in essence, restricts the kinds of housing that can be operated on a cooperative basis. It prevents stable and financially sound business ventures from securing proper leases and making other socially and economically desirable arrangements with cooperatives, and leads to uneconomic uses of the properties. Because the commercial portions of the properties are underutilized, the government actually loses tax revenue.

An example of the difficulties created by this unnecessary restriction can be seen in the case of a project designed for the elderly or handicapped. Ideally such properties should contain various ameneties, such as one or two medical offices, a pharmacy, a grocery, and a laundry. It might also contain other retail stores, and even a movie theater, etc., for the convenience of the tenants for whom the trips to distant locations may be a hardship. The present 80-20 test greatly limits our flexibility in creating suitable facilities for such senior citizens.

This restriction does not exist for condominiums, and its absence in that situation has created no tax problems at all. It exists only for cooperatives. Yet, as a policy matter, there is no reason perceived for the tax law to discriminate against cooperative housing corporations as compared to condominiums. The choice of format to use in creating owner-occupied multiple dwelling facilities, that is, cooperatives vs. condominiums, should depend on local legal and economic factors, such as zoning laws, not the idiosyncracies of federal tax laws.

In the case of cooperatives, not only is the government losing taxes, it is losing them twice. It is losing tax revenues from the businesses that are thwarted from entering the cooperative complex, and it is losing the taxes which the cooperative corporation would have to pay on the income that it would earn from the particular businesses. In this time of budget austerity, it does not appear to me that this makes much sense.

In support of the bill, I am submitting a Report of a Special Subcommittee of the Real Property Section of the New York State Bar Association on Proposed Amendments to Section 216 of the Internal Revenue Code, written by Martin Cowan, Esq., Frank E. Karelsen, III, Esq., William Jay Lippman, Esq. and Joel Miller, Esq., to which I respectfully refer the members of this committee. The report does not address specifically the two amendments to Section 216 made by this bill, because the Report actually contains much broader recommendations for simplification and reform of Section 216. However, its proposals are wholly consistent with the provisions of this particular bill.

In conclusion, to state the issue simply, both the government (twice) and the cooperative movement in this country are losing revenues, and our urban housing supply is also suffering. The amendments being proffered today will help ameliorate these conditions.

Respectfully submitted,

FRANK E. KARELSEN, III

STATEMENT OF RALPH F. COLIN, JR.

My name is Ralph F. Colin, Jr. and I am here today representing the tenant/owners of the 33 East 70th Street Corporation, a cooperative residence corporation of which I have been a board member for 14 years and of which I have been President since May of 1975. The 33 East 70th Street Corporation has 65 apartments and an annual budget of over $1½ million. It is located in New York City on Madison Avenue with entrances on both 70th Street and 71st Street. In addition to the residential apartments, there are also five commercial establishments which rent space from the cooperative and one of those commercial establishments sublets some of its space to two other commercial renters. In all, therefore, there are seven non-residential and non-coop tenant businesses located in the building.

Madison Avenue is one of the prime commercial thoroughfares in New York City. In this particular area, a very desireable one, most of the businesses are upscale establishments; many of them are boutiques, art galleries, gourmet food stores and other such businesses which are normally in a position to pay the kind of high rent which the location demands. In our situation, and for others who may be faced with the identical problem of the restrictions of Section 216, the commercial establishments are paying a rent substantially below that of neighboring stores. While this may be advantageous to them, it certainly is not helpful to the cooperative in maintaining a rather extensive plant and I would think it was also apparent that the loss of potential tax revenues from the commercial income which might otherwise be derived, would also be an unnecessary one from the point of view of the government.

It is very simple to see what happens in a case like this. Our building management advises us that without the 80/20 restrictions, we could be obtaining $997,000 in commercial rents putting us on an equal footing with those commercial landlords who rent space adjacent to ours. But because of the restrictions of Section 216, we are limited to collecting just a little over $300,000 from non-residential sources. This, of course, puts a far greater financial burden on the tenant/owners of the building, some of whom are elderly and retired and may be on fixed incomes. While it is granted here that the financial burden in this particular case may not be so overwhelming, I suspect that in other areas of the city or of the country where cooperatives are similarly restricted by Section 216, the burden could be quite considerable and conceivably could make the difference between a person's ability to retain his or her apartment or, in the alternative, having to sell it because of increasing maintainence costs.

It would seem that this all boils down to the question of what benefits, if any, are derived - and by whom - by the continued existence of the 80/20 limitations in Section 216. Certainly the government does not benefit from this restrictive provision; its potential for increased tax collection is blocked. And it has been demonstrated that the tenant/owners in a cooperative situation suffer as a result of the section's strictures. Therefore, as a layman, it would seem to me to make a great deal of sense to amend this section so as to provide considerable financial relief to residential tenants while at the same time increasing the tax base from those commercial establishments who can certainly afford to pay a higher rent.

I hope that your committee will give careful consideration to this matter and I want to thank you for the opportunity that you have given me to appear before you today.

TESTIMONY OF BREWSTER IVES

at a hearing of the Sub-Committee on Taxation and Debt Management of the Senate Committee on Finance

November 6, 1981

My name is Brewster Ives. I am chairman of the board of directors of Douglas Elliman-Gibbons & Ives, Inc., real estate, 575 Madison Avenue, New York, New York. I have in fact specialized for over fifty years in the sale and promotion of cooperative and condominium apartments in the City of New York as well as in the management of well over 200 large cooperative and condominium apartment houses located in that city. I have also served as a director of the Tenant-Owned Apartment Association, Inc., for over fifty years and am presently serving as its President for the past four years as well as a previous four-year term. In addition I am also a director of The Fifth Avenue Association of the City of New York and have served on many committees concerning matters affecting cooperative and condominium apartments throughout my business life. My firm is presently engaged in the marketing and selling of the condominium apartment tower now under construction over the Museum of Modern Art as well as the recently constructed Olympic Tower and Galleria Condominiums and the twin tower cooperative buildings facing the United Nations known as 860 and 870 United Nations Plaza, all of these being properties of world-wide distinction.

As President of the Tenant-Owned Apartment Association, Inc., which represents the interests of well over 40,000 individual cooperative apartment owners, I welcome the opportunity to discuss with you the problems created by Section 216 of the Internal Revenue Code. Cooperative apartment corporations have been unfairly and unreasonably hampered by reason of the 20% limitation placed upon their income which is not permitted to be derived from any source other than cooperative apartment owners as individuals, in order for apartment owners to take advantage of their right as home owners to deduct their proportionate share of real estate taxes and mortgage interest paid by their cooperative buildings. I clearly recall that this section of the code was adopted forty years ago by the Congress, which our Association helped in sponsoring, in order to maintain the principle of affording the same rights to cooperative apartment owners as allowed other home owners including those who own private dwellings and condominium apartments. There are many cooperative apartment corporations presently suffering from this limitation which have had to sacrifice additional income in order to preserve their right to their income tax deductions. This has resulted in foregoing more substantial commerical lease rentals and this has resulted in loss to both the cooperative owners concerned as well as governmental tax revenues. Forty years ago when we applied for this legislation resulting in Section 216 there was no one, including myself, who was aware of the reasoning behind the 80/20% income restriction but we were so anxious for the principle to be established of allowing the same right of tax deductions that we accepted the 80/20% limitation formula without protest. We now have learned from actual experience and the workings of the Internal Revenue Code that this has severely hampered the development of cooperatives to the point where the vehicle of condominium ownership has been substituted for cooperative ownership by virtually all new construction for the last several years. It was certainly not the original intent of Congress to favor one form of home ownership against another which this section has accomplished. It was merely happenstance and not a rational limitation that the formula of 80/20% was written into the code. It was a percentage which was simply taken out of the air to ensure that the property remains residential in character. Condominiums on the other hand permit apartments to be owned by corporations, partnerships, diplomatic missions and governmental agencies as long as their use by their representatives is residential in purpose. In consequence, condominiums are presently favored over cooperatives and these differences make no sense in either logic or in practice as long as the primary purpose of the corporation is to provide dwelling space for its owners. An increase from 20% to a minimum of 50% is called for as this bill provides.

If Congress fails to correct this inequity for cooperative apartment corporations it will be doing a great disservice to the cooperative home ownership movement throughout the entire nation from New York to California and from Texas to Florida. The spread of the cooperative ownership movement throughout the country is one of our prime sources of strength in our present day economy and it would accomplish a millennium if all residents throughout our nation could become home owners, either through ownership of private dwellings, condominiums or cooperative apartments without favored tax treatment for one form of ownership against another.

Respectfully submitted,

Brewster Ives

Brewster Ives

REPORT OF A SPECIAL SUBCOMMITTEE OF THE REAL PROPERTY SECTION OF THE NEW YORK STATE BAR ASSOCIATION ON PROPOSED AMENDMENTS TO SECTION 216 OF THE INTERNAL REVENUE CODE

On May 20, 1980, the Honorable Les Aspin (Dem., Wisc.) introduced H.R. 7383, which would amend section 216(b)(1)(D) of the Internal Revenue Code by substituting 50% for 80%. In his statement on the floor of the House when he introduced the bill (Cong. Rec. E 2495, May 20, 1980), Congressman Aspin recognized that there were a number of other problems with section 216, and invited proposals for additional amendments to correct these problems. This report is written in response to that invitation, and contains both proposed statutory language and a discussion of the problems that such an amendment would cure.

Present Law

Generally, under section 216 of the Internal Revenue Code a "tenant-stockholder" in a "cooperative housing corporation" is entitled to deduct amounts paid to such a corporation to the extent such amounts represent his or her "proportionate share" of deductible real estate taxes and interest relating to the corporation's land and buildings. In appropriate cases, "tenant-stockholders" may also deduct depreciation with respect to their respective units. In order to qualify as a "cooperative housing corporation", subparagraph (D) of section 216(b)(1) requires that the corporation derive 80% or more of its gross income for the taxable year from its "tenant-stockholders".

In order to qualify as a "tenant-stockholder", a stockholder must, among others, meet one of the following requirements:

(1) The stockholder must be an individual;

(2) The stockholder must be a bank or other lending institution which has acquired its interest by foreclosure or instrument in lieu of foreclosure from a qualified tenant-stockholder (but it will qualify only for a period of up to three years after such acquisition); or

(3) The stockholder must be an "original seller", as defined in section 216(b)(6), or the estate of an "original seller". An "original seller" is the person from whom the cooperative housing corporation acquired the apartments or houses (or leaseholds therein). The "original seller" must have acquired the stock either (a) by purchase from the corporation within one year of the original transfer to the corporation, or (b) by foreclosure (or instrument in lieu of foreclosure) of any purchase money security interest in the stock held by the "original seller". Qualification under the "original seller" provision can extend only for a period of up to three years after the acquisition.

In addition, an order for a stockholder to qualify under section 216(b)(2), his stock must be "fully paid-up in an amount not less than an amount shown to the satisfaction of the Secretary as bearing a reasonable relationship to the portion of the value of the corporation's equity in the houses or apartment building and the land on which situated which is attributable to the house or apartment which such individual is entitled to occupy."

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Reasons for Change

The 80% requirement in section 216(b)(1)(D), combined with the limitations on the kinds of stockholders who can qualify as a tenant-stockholder under the statute, impose certain restrictions on cooperative housing corporations which appear to be unwarranted and counterproductive and result in unintended hardships. Condominiums are similar to cooperative housing corporations in purpose and function, but no such restrictions are imposed on condominiums. The decision to use a condominium format, rather than a cooperative housing corporation, depends on a number of factors, including local real estate conditions and the type of financing needed, but these factors should not be relevant with respect to federal income tax consequences, and do not justify divergent tax treatment.

The 80% requirement limits the flexibility and utility of the cooperative housing corporation in several ways. For example, in a building with a number of elderly or handicapped tenants, it may be very useful to have commercial occupants, such as laundries, pharmacies, and groceries, within the building itself. However, the receipt of rentals from such commercial tenants in the building could well disqualify the corporation under section 216. In some cases, churches have been unable to purchase housing units for their clergymen or for use in religious activities, and other eleemosynary organizations have encountered similar difficulties, because they can not qualify as tenant-stockholders.

Disqualification under Section 216 because of a violation of the 20% limitation on non-qualified income may be completely inadvertent or the result of events beyond the control of the taxpayers. For example, in a building which derives close to 20% of its gross income from stores, the death of a qualified individual tenant-stockholder will result in disqualification if the income from that unit, combined with the commercial rent, will then exceed 20%, because the decedent's estate does not qualify as a tenant-stockholder. A similar result may follow where one or more stockholders surrender their stock to the corporation, especially if the corporation attempts to reduce its losses by renting the units before resales can be arranged. Also, if the rent for a store space is in any way contingent (e.g., based on sales, or adjusted for cost-of-living factors), the rent in some years may unexpectedly increase beyond the 20% limit, again resulting in inadvertent disqualification. Problems may also arise, even where the non-qualified income is normally less than 20%, if the corporation uses the cash method of accounting and either tenant-stockholders or non-stockholder tenants fail to make rental payments when due. In the latter case, the cooperative housing corporation may lose its qualification as a result of the commercial tenant's making good on its delinquencies for a prior year.

Cooperative housing corporations which foresee such problems can sometimes (but not always) limit the risk of inadvertent disqualification by leasing the commercial spaces at less than fair market value. Often, the lessee is the original sponsor or transferor. The result is that the economic structure of the building is distorted, to the benefit of the sponsor or transferor and to the detriment of the tenant-stockholders, just to qualify under section 216.

If a cooperative housing corporation is disqualified under section 216 because of its failure to meet the 80% test, the deductions are usually disallowed only to those individuals who do qualify as tenant-stockholders and, hence, should be entitled to the deduction. In most cases, the tenants who do not qualify tenant-stockholders (e.g., commercial or corporate tenants, and whose payments to the corporation cause the disqualification will nevertheless be entitled to claim as ordinary and necessary business expenses under section 162 or as expenses incurred for the production of income under section 212 all or almost all of the deductions unavailable under section 216. Thus, the persons who should as a matter of policy be entitled to the deductions lose them, and the persons who cause the disqualification get them anyway.

Possibly, when the predecessor of section 216 (section 23 (z) of the 1939 Code) was first enacted in 1942, it may have been believed that the 80% requirement was necessary to limit the ability of a cooperative housing corporation to earn large amounts of commercial income and apply such income to the personal housing costs of the tenant-stockholders, without either the corporation or the tenant-stockholders paying tax on that income. For several reasons, this concern is no longer justified. Among other things, it is now clear that section 277 requires the cooperative housing corporation to pay tax on the proper amount of commercial income, and experience with condominiums confirms that there is no real need for the 80% requirement for cooperative housing corporations.

However, there is one reservation with respect to the complete elimination of the 80% test. Some commentators have indicated that section 216 should not apply to a corporation which functions essentially as a commercial or industrial operation and which only incidentally owns residential property which it leases to one or more of its stockholders. Thus, a two-stockholder corporation which has a multi-million dollar industrial plant, and which also owns two homes which it leases to its two stockholders, should not be able to qualify under section 216. There is probably not a significant potential for tax abuse in this situation, 1/ but, to eliminate any doubt, there should be a requirement that a cooperative housing corporation must have as its principal purpose the providing of residential housing to its tenant-stockholders. This is consistent with present concepts, and would give the Internal Revenue Service ammunition to prevent any substantial abuse.

A sublease of a dwelling unit by a stockholder will not be deemed inconsistent with the corporation's purpose of providing residences for its stockholders.

Of course, a "principal purpose" test is sometimes difficult to administer in practice, but in this context this should not be a major problem. It would be intended primarily as an *in terrorem* provision, which the Service could apply in extreme cases. However, as long as 50% of the corporation's gross income came from its tenant-stockholders, the principal purpose test would be satisfied. Moreover, even if the income from tenant-stockholders in a particular year fell below 50%, *e.g.*, because of vacancies, bankruptcies or other conditions beyond the control of the corporation, the corporation would still be able to satisfy the principal purpose test by showing either, that, over a period of several years, more than 50% of its income has been and will be

1/ Reference to condominiums again confirms that this is not likely to be a serious problem. There are many commercial-residential combination condominiums today. For example, a common arrangement is a condominium consisting of two classes of units, one of which is commercial in nature and the other of which is residential. Nothing restricts a condominium from having 98% commercial units and 2% residential units. Little opportunity for tax abuse seems to arise in such contexts.

realized from residential tenant-stockholders, or that the conditions which caused it to fall below 50% were beyond its control and that it is actively working to correct those conditions. In considering the corporation's purpose in leasing space to non-residential tenants, the Service may take into account the fact that such tenants provided goods or services auxiliary to the residential nature of the property. This might include churches, daycare centers, and recreational facilities.

Similarly, there is no need for the general requirement in section 216(b)(2) that a "tenant-stockholder" be an individual. This requirement disqualifies such entities as decedents' estates, estates of bankrupt individuals, and marital deduction trusts, for no apparent reason of policy. Most of these types of taxpayers, being entitled to deductions under section 162, generally would not seek to rely on section 216 in any event, so that the only major effect of their disqualification as tenant-stockholders would be to deny the deduction to the other taxpayers who are qualified tenant-stockholders.2/ Again, there is no comparable requirement for condominiums, and experience in that area confirms that there is no need for the restriction. Eliminating this requirement would result in substantial simplification of the statute, since paragraphs 5 and 6 of section 216(b), and the many problems inherent in those provisions and the need for possible lengthy regulations interpreting them, would be eliminated.

2/ They might also lose part or all of the deduction for depreciation under section 216(c), but this is not a significant item for most taxpayers.

The requirement in section 216(b)(2) that the stock be "fully paid-up in an amount no less than an amount shown to the satisfaction of the Secretary as bearing a reasonable relationship to the portion of the value of the corporation's equity in the houses or apartment building on the land on which situated which is attributable to the house or apartment which such individual is entitled to occupy" is, at best, barely comprehensible. Few, if any, experienced tax attorneys claim to understand how to apply this test in practice. For example, it is not clear whether sponsors offering stock for sale may offer discounts to tenants in occupancy, or to people who commit to buy before completion of construction, or to tenants entitled to the protection of rent control laws. Nor is it clear whether a sponsor may change prices to reflect shifts in values during the offering period.3/ If he does any of these, he may violate the statutory test; but if he does not, he distorts the economic relationships and produces unintended windfalls for some at the expense of others.

3/ The regulations require the relationships among values and prices to be determined on the date the stock is issued, which is at the end of the offering period. In at least one state, the offering can occur over a period of up to 18 months or in some cases, longer. Leaving aside fluctuations in market value, even ordinary inflation during this period may cause two units of equal value to vary in price by as much as 20% during the offering period. If one such unit is sold at the beginning of the offering period and the second unit is sold at the end of the offering period, it may be impossible under the statute to sell both units at their fair market values at the times the respective sales contracts are negotiated and signed. It may well be, therefore, that the second purchaser will receive a substantial bargain, or that the first purchaser will overpay, or that the sponsor will withdraw the second unit from the market entirely.

The statute is also unclear as to what happens if stock is issued on more than one date, as, for example, when new units are added to an existing building or space initially held by commercial tenants is converted to residential use subsequent to the original offering.

It does not appear that any cooperative housing corporation has ever been disqualified for failing to meet this test, but it has greatly complicated matters and increased costs without any beneficial purpose or result.

Nor is it clear what "paid-up" means in this context. Most cooperative housing corporations collect from their shareholders funds to amortize mortgage principal or for capital improvements, but the Internal Revenue Service has not raised any question about this. A significant problem is that, because of the presence of this requirement, a seller will normally not permit a purchaser to pay for stock with promissory notes, thus making cooperative ownership more difficult for less affluent individuals. In any event, the need for the requirement (again, missing in condominiums) is not apparent.

Section 216(b)(1)(C) states that stockholders may not be entitled "to receive any distribution not out of earnings and profits of the corporation except on a complete or partial liquidation of the corporation. . ." (Emphasis added.) In section 528, dealing with homeowners associations, the rule is just the opposite: under section 528(c)(1)(D), the owner of a dwelling unit may not receive any distribution which is out of "net earnings". The two rules should be the same, and the rule in section 521 is the better one. Indeed, it is very likely that this is the rule that Congress intended to provide for cooperatives: the language that now appears in section 216(b)(1)(C) apparently resulted from a drafting error, since the Committee report stated that the intended restriction was that stockholders "must not be entitled to receive any distribution of the earnings or profits of the corporation except upon its complete or partial liquidation."4/

If the foregoing changes are made, it becomes unnecessary to tinker with paragraphs (5) and (6) of section 216(b). They can merely be repealed and the statute simplified. However, if the definition of "tenant-stockholder" is not liberalized as suggested above, then an additional technical change needs to be made. Any person who acquires the stock of a tenant-stockholder by operation of law should qualify as a tenant-stockholder for a period of up to three years (the length of time adopted in paragraphs (5) and (6)). This would cover such persons as decedents' estates and estates in bankruptcy.

A trust should also qualify in appropriate cases, as, for example, where a marital deduction is granted under section 2056 or section 2523 for property transferred to the trust and the transferor's spouse (or his or her sustenant) has the right

4/ S. Rep. No. 1631, 77th Cong., 2d Sess., at 51 (1942), 1942-2 C.B. 504, 546.

to occupy the unit. The trustee or executor could also have the right of occupancy on a temporary basis for administrative purposes (i.e., three years).

Finally, certain other successors-in interest should qualify as original sellers. This would include transferees in tax-free transactions (e.g., reorganizations and transfers to controlled corporations under Section 351 or to partnerships under section 721), distributees (e.g., corporate distributions under sections 301, 331, 332, or 333 or partnership distributions under section 731), the beneficiaries and remaindermen of trusts, and legatees. In these cases, where there has been for tax purposes no cognizable change of beneficial ownership, there is certainly no reason to disqualify the successor-in-interest, with its potentially disasterous effect upon the other stockholders. However, the successor-in-interest should be permitted to qualify only for the remainder of the original three year period.

Explanation of Changes

The 80% test has been eliminated, and a "principal purpose" test substituted. The phrase "tenant-stockholder" is deleted, since it does not appear to be necessary. However, the corporation will not satisfy the definition of a cooperative housing unless its stockholders meet the desired requirements. Stockholders need not be individuals. Assuming the corporation satisfies the definition, its stockholders will be entitled to claim the appropriate deductions.

The stockholder's deductions are specifically limited to the portion of the taxable year for which the stockholder owns the stock. In addition, only the real estate taxes and interest deductible by the corporation with respect to the dwelling units on stockholders can be taken into account in computing the stockholders' deduction. Any portion of the corporation's real estate taxes and interest allocable to other portions of the property (for example, to professional apartments leased to non-stockholders) would be taken into account in determining the corporation's taxable income, but not the stockholders' deductions. This eliminates certain technical ambiguities in the present statute.

In substitution for the present "paid-up" and "reasonable relationship" tests of section 216(b)(2), there is instead a requirement that the stock be allocated to dwelling units substantially in proportion to their respective unrestricted fair market rental values on the dates of issuance. As long as such allocations are made properly, the selling price of the stock is immaterial.5/ Thus, the temporary effects of rent control would not be projected indefinitely into the future. The proposed statute only requires that the allocation be "substantially" in proportion to rental values. Accordingly, minor differences of opinion as to value would not result in disqualification. If stock is issued on different dates, it is contemplated that the stock issued on each date would have to meet this test by reference to relative values on that date.

5/ Of course, if not-at-market-value sales constituted gifts or substitutes for other payments of various sorts, the tax consequences appropriate to those transactions would apply. However, that would not affect qualification under section 216.

It is intended that existing corporations that qualify under present section 216 will not be disqualified because of this requirement.

Under the certificate of incorporation, by-laws or other corporate documents or agreements, the ownership of stock must confer the status of tenant of the corporation on the stockholder, or it must entitle him to become a tenant of the corporation, and he must in fact become a tenant. Thus, this requirement may be satisfied even though the stockholder is required to enter into and comply with the terms of a lease as a condition of his tenancy, and of his continuing ownership of the stock. Although perhaps not stated in the present statute as clearly as it might be, this is the rule that now exists.6/ The proposed language will eliminate the question that is sometimes raised under the wording of the present statute where there is a statutory or contractual subtenant. Thus, it will be clearly irrelevant that a third party occupies the apartment as a result of his rights under local rent control laws, so long as the stockholder is the prime tenant of the corporation and the occupant is a subtenant of the stockholder, whether by virtue of a voluntary lease or otherwise.

The stockholder must be required to contribute to the corporation his proportionate share of the real estate taxes and interest paid or incurred by the corporation with respect to the residential portions of the premises as to which stock is outstanding.

6/ Reg. §1.216-1(d)(2).

Stock held by the corporation is excluded, rather than included. This is a technical change required because of the manner in which the proportionate share is computed under the proposed revision. It should be noted that, where the corporation has funds from other sources, it may charge stockholders less than the full amount of interest and taxes incurred during the taxable year. It is contemplated that the stockholders may deduct the larger amount so long as no abuse is involved.7/

Proposed section 216(b)(2) defines "dwelling unit". It is intended to include a unit which is physically usable as a dwelling unit, even though not presently used as a residence and (in order to relieve the Internal Revenue Service of the necessity of interpreting building codes and the like) regardless of whether or not residential occupancy is permissible under local requirements. Thus, a professional apartment used by a doctor or a lawyer can qualify, whether or not covered by a residential certificate of occupancy. Also, a unit is not intended to be disqualified merely because minor changes in the unit (such as the installation of appropriate appliances) may be necessary before it can be used for dwelling purposes. A dwelling unit does not include a dormitory or hotel room or other space suitable only for transients or other temporary residents. However, a unit otherwise usable as a permanent residence is not necessarily disqualified merely because it does not have all of the common amenities.

7/ Such other funds may be received from some or all of the tenant-stockholders themselves. See, e.g., Rev. Rul. 79-137, 1979-1 C.B. 118, where the corporation realized income from tenant-stockholders who sold their units and paid a brokerage commission on such sales to the cooperative housing corporation. Cf. Concord Village v. Comm'r, 65 T.C. 14 (1975), appeal dism. (C.A.9).

A dwelling unit includes the appropriate portion of the corporation's interest in any land and in the common elements (such as hallways, playgrounds, utility rooms) associated with the houses or apartments. It would not include that portion properly allocable to commercial premises or which is otherwise extraneous to the residential uses of the property.

As under the present statute, stock owned by certain governmental units 8/ will not be taken into account for purposes of determining the proportionate share, and will not be deemed a second class of stock. 9/

Effective Date

Because this provision would eliminate many unnecessary problems, it will be effective immediately for all open years.

Respectfully submitted,

8/ The class of government agencies is slightly broadened to reflect the rules as presently being applied. See, e.g., Reg. §1.216-1(d)(1); Rev. Rul. 78-261, 1978-2 C.B. 125; Rev. Rul. 120, 1953-2 C.B. 130.

9/ FHA financing commonly requires a special type of stock to be issued to the government agency.

§ 216. Deduction of taxes, interest and business depreciation by cooperative housing corporation stockholder

(a) Allowance of deduction.--A stockholder in a cooperative housing corporation shall be allowed as a deduction--

(1) to the extent paid or accrued by him, his proportionate share, for the period within the taxable year that he is a stockholder, of the deductions allowable to the corporation--

(A) under section 164 for real estate taxes paid or incurred with respect to dwelling units of which stockholders are tenants, and

(B) under section 163 for interest paid or incurred with respect to indebtedness contracted in the acquisition, construction, alteration, rehabilitation, or maintenance of dwelling units of which stockholders are tenants, and

(2) under regulations prescribed by the Secretary, an allowance for depreciation under section 167(a) to the extent that the dwelling unit of which the stockholder is the tenant is used by him in a trade or business or for the production of income. Nothing contained in this section shall be construed to limit or deny a deduction for depreciation by the corporation under section 167(a).

(b) Definitions.--For purposes of this section--

(1) Cooperative housing corporation.--The term "cooperative housing corporation" means a corporation--

(A) the principal purpose of which is to provide dwelling units for its stockholders,

(B) having one and only one class of stock,

(C) all of the issued stock of which was, on the date of original issuance, allocated to dwelling units substantially in proportion to their then unrestricted fair market rental values, and

(D) each of the stockholders of which--

(i) by reason of such stock ownership is the tenant of a dwelling unit

(ii) is required to contribute to the corporation his proportionate share of the real estate taxes and interest referred to in subsection (a)(1), and

(iii) may not receive a distribution from the corporation except upon a complete or partial liquidation.

(2) Dwelling unit.--The term "dwelling unit" means a house or apartment, including an allocable portion of the land and common elements associated therewith, whther owned or leased.

(3) Proportionate share.--The term "proportionate share" means that proportion which the stock of the corporation owned by the stockholder is of the total outstanding stock of the corporation (excluding any stock held by the corporation).

(4) Stock owned by governmental units.--In applying this section (other than subsection (b)(1)(A)), there shall not be taken into account stock of a separate class, or otherwise having special rights or privileges, owned by the United States or any of its possessions, a State or any political subdivision thereof, or any agency or instrumentality of the foregoing empowered to acquire shares in a cooperative housing corporation for the purpose of providing or facilitating the provision of housing facilities.

[By direction of the chairman the following communications were made a part of the hearing record:]

gw

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

DEC 24 1981

Dear Mr. Chairman:

I am writing you to clarify certain points raised during the recent hearing on S.1749. The bill would amend Code section 162(c)(1) to disallow deductions for payments to foreign government officials only when such payments violate the Foreign Corrupt Practices Act. On November 6, 1981, I testified in favor of S.1749 and we continue to support its enactment. In the course of the hearing, however, there was a misunderstanding concerning the significance, for purposes of Code section 162(c)(1) as amended by S.1749, of a finding that a payment is legal or illegal under foreign law. This issue is complicated by reason of the possible amendment of the Foreign Corrupt Practices Act by S.708, which was just approved by the Senate.

If S.1749 is enacted and the Foreign Corrupt Practices Act is amended by S.708, then a payment to a foreign official would not violate U.S. law and would be deductible if, among other things: the payment is a "grease" payment, whether or not it violates foreign law; or, the payment would violate U.S. law if made to a U.S. Government official but does not violate the law of the country of the foreign official in question.

Thus, S.1749 and S.708 would make certain payments to foreign officials legal and deductible because they do not violate foreign law. And, certain payments such as "grease" payments would be legal and deductible even if they violate foreign law.

If the Foreign Corrupt Practices Act is <u>not</u> amended by S.708, and S.1749 is enacted, then deductions would be disallowed without regard to whether a particular payment is legal or illegal under foreign law. The current provisions of the Foreign Corrupt Practices Act do not take into account how foreign law characterizes a payment.

In the interest of assuring that the record is accurate on this issue, I have suggested amendments for the transcript of my oral statement at the November 6, 1981 hearing. I hope this meets with your approval. If you have any questions about this letter or the transcript, I would be pleased to discuss them with you.

I have also written Senator Byrd and Senator Chafee concerning this matter.

Sincerely,

John E. Chapoton
Assistant Secretary (Tax Policy)

The Honorable
Bob Packwood, Chairman
Subcommittee on Taxation and
Debt Management
United States Senate
Washington, D.C. 20510

ASLA

American Society of Landscape Architects

William A. Behnke
President

November 5, 1981

The Honorable Bob Packwood
Chairman, Subcommittee on Taxation
and Debt Management
United States Senate
Washington, DC 20510

Dear Senator Packwood:

The American Society of Landscape Architects is vitally interested in service liability partial self-insurance. We support S-1081 (the Design Liability Supplemental Protection Act of 1981) sponsored by Senator Mathias and others, and urge your committee to take positive action on it.

This legislation is essential to professionals in the field of landscape architecture. Our profession, together with the architects and the engineers, has been hard-hit by the rising cost of liability insurance. Firms that practice landscape architecture are small businesses with over 90% of them having under 20 employees. Today the tax code gives substantial tax advantages to the purchases of commercial insurance, but those who wish to self-insure against professional liability risk are still penalized.

A very small percentage of the landscape architectural firms set aside reserve funds for liability purposes in addition to their insurance coverage. However, the current insurance premiums are so high that the practitioners cannot pay them and set up a reserve fund as well. The fact is that very few, if any, reserve funds are established. S-1081 would provide an equitable method for small firms to set aside funds to help cover insurance requirements. These firms would establish a separate trust fund if the allocation were tax-deductible as a cost of doing business.

This legislation will greatly assist many of our firms to stay in business and to fulfill their responsibility to the public by having proper professional liability insurance coverage.

1900 M Street, N.W. Suite 750 • Washington, D.C. 20036 • 202 • 466-7730

November 5, 1981
Senator Packwood
Page Two

We believe it is important to recognize an inequity in the tax laws, and the passage of this legislation will be a big step in helping the financially hard-pressed design service industry.

Section 2 (10) (A) (i) under SERVICE of S-1081 is sufficiently broad to cover the work of the landscape architect. Therefore, we propose only a small addition to (ii) which will certainly bring our profession under the bill. We request that the words "landscape architect" be added to (ii) under (A) SERVICE, (10) Definitions.

The proposed legislation uses, as a basis for eligibility, "state licensure" of a design professional. It should be pointed out that many states are currently in the process of reviewing licensure for professionals under "Sunset Procedures". Therefore, it should not be assumed that this method of designating eligibility is sufficiently broad to accommodate situations where a state chooses to sunset licensure in one or more of the design professions. Because of this potential problem, your committee may wish to reevaluate this eligibility requirement. It is suggested that further discussion of this issue is warranted.

We request that this letter be made a part of the official hearing record of November 6, 1981, on S-1081.

Thank you for your consideration of this request.

Sincerely,

William A. Behnke

William A. Behnke, FASLA
President

WAB/amt

STATEMENT

OF THE

NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

COMMITTEE ON FINANCE

UNITED STATES SENATE

ON

S.1081

SERVICE LIABILITY PARTIAL SELF-INSURANCE ACT OF 1981

ON

NOVEMBER 6, 1981

Mr. Chairman, we appreciate the opportunity to express our views on S.1081.

The National Association of Independent Insurers (NAII) opposes S.1081 for several reasons. First, we do not believe the proponents of this bill have demonstrated the need for this legislation. Second, we believe the proposal will not accomplish its stated purpose. Third, we believe the bill could be counterproductive in resolving the issues sought to be addressed by this legislation.

NAII is a voluntary trade association of over 500 insurers representing a cross-section of the property and casualty insurance business in America. While our companies write basically personal lines, several member companies write product and professional liability insurance, including a substantial amount of the design professional market.

S.1081 would amend the federal tax laws to permit deductions from income for amounts paid either into a reserve fund or to a captive insurer to cover professional liability for design professionals, architects and engineers. Interest paid on such funds would not be subject to taxation.

It is our view that the need for this legislation has not been established. We believe the insurance needs of design professionals, architects and engineers are being adequately met by the insurance industry. According to our information, availability of insurance is not a problem in this market.

To provide support for this legislation, its proponents have offered statistics of rising premium rates and percentage increases over the past two decades. Based on data supplied from member companies, we believe some of these figures are highly inflated and of questionable validity. In addition, while coverage costs have indeed risen over the past 20 years in this industry, the cost of virtually every product and service used by the American consumer has doubled and, in some cases, tripled because of inflation during that time. It is therefore inappropriate for this industry to be singled out for special treatment.

Furthermore, we believe recent information provides a more realistic picture of the situation as it presently exists in this market. In the past four years, the market has become much more competitive with four new entrants,* along with broadened coverages and higher policy limits. Premium rates are continuing to decline despite inflationary trends present in the economy generally. Premium rates have declined an additional five to ten percent since we filed a statement opposing this legislation last year.

Another reason for rising insurance costs over the past two decades was explained by Senator Mathias in his statement introducing the bill: "Over the past 20 years, product liability laws have changed substantially, making it easier for the consumer to recover damages for injuries attributable to defective products. These changes have exposed the suppliers of

*Insurance Company of North America, Allianz, the American International Group, and Professional Managers, Inc.

products to potentially ruinous liability and, in turn, have increased the cost of insurance that these suppliers must pay to protect themselves from such liability."

Thus, a significant reason for rising costs is the fact that product makers and professionals are being held more accountable to consumers than ever before for the quality of their work. If controls are needed to improve the quality of products and services, or to limit the scope of this responsibility and to set outer limits on recoveries in product or professional liability cases, tort reform or other legislative approaches at the state level would be the proper method to achieve these goals.

We also do not believe that this bill will adequately address the insurance concerns of firms of design professionals, architects and engineers. This proposal does not provide for traditional insurance services for the businesses involved, such as claims services, claims handling or legal services which would be necessary in handling such claims. The proposal merely provides a means of tax-free savings for a business which on any given day may be confronted with a liability claim. The plan does not even offer insurance protection, in the traditional sense, to businesses or to the public. Both would be gambling on whether such a fund would be adequate enough at a given time to pay any and all claims.

The amounts to be retained in such funds may also be inadequate as a result of the ceiling set forth in the bill which limits contributions to no more than $25,000 per year ($100,000 for firms with severe problems). At that low rate, it would take many years to accumulate enough in any such fund to pay off a sizeable claim. Senator Mathias' statement accompanying the bill suggests that in practice, most design professionals would choose to use the fund only to cover their insurance policy deductibles and would purchase conventional insurance to cover additional exposure. However, the bill is not drafted in such a way as to require that the funds be used only in that manner.

Even if adequate amounts were paid into such a fund, without proper regulation and monitoring of reserves and investment practices, as well as claims and settlement practices (the way insurance companies are supervised by state regulatory authorities), there would be little assurance a particular company would be in a position to respond to legitimate claims the way a commercial carrier would.

This tax deduction program would thus encourage firms to pursue actuarially unsound self-insurance programs merely to gain apparent tax advantages. It would also place firms with no insurance expertise, skills or disciplines in the business of insurance since they would have to assume responsibility for all traditional claims services.

Finally, we believe this bill could actually be counterproductive to efforts that are underway between the insurance industry and the states to control costs. Since it is the frequency and severity of liability awards which will prompt insurers to raise rates, efforts to control costs (in addition to inflation-control measures) must be centered around tort reform and delivery of better quality products and services. The insurance industry currently is working with the National Association of Insurance Commissioners (NAIC) in developing new product and new rating methods, as well as state tort reforms, to meet this challenge of expanding liability awards.

In conclusion, NAII opposes S.1081 because: (1) the need for such legislation has not been demonstrated, (2) the proposal will not accomplish its stated purpose, and (3) the legislation could be counterproductive.

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