1962

Taxation-Federal Income Tax-Strike Insurance Agreements

Robert A. Butler S.Ed.
University of Michigan Law School

Follow this and additional works at: <https://repository.law.umich.edu/mlr>

Part of the [Administrative Law Commons](#), [Contracts Commons](#), [Insurance Law Commons](#), [Litigation Commons](#), [Taxation-Federal Commons](#), and the [Tax Law Commons](#)

Recommended Citation

Robert A. Butler S.Ed., *Taxation-Federal Income Tax-Strike Insurance Agreements*, 60 MICH. L. REV. 474 (1962).

Available at: <https://repository.law.umich.edu/mlr/vol60/iss4/4>

This Response or Comment is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

COMMENTS

TAXATION—FEDERAL INCOME TAX—STRIKE INSURANCE AGREEMENTS—Contracts indemnifying persons or corporations for losses and damage resulting from an interruption of business due to strikes have existed at least since the beginning of this century. The Mutual Security Company of Connecticut, for example, wrote such a policy for the Buffalo Forge on April 9, 1906.¹ In more recent times, strike insurance agreements have been instituted in major industries, and their impact on collective bargaining has been the subject of some controversy. The purpose of this comment is to consider the federal income tax questions which arise from such arrangements. Specifically, attention is directed to the deductibility of payments constituting the “premium” for strike insurance, with particular emphasis on whether such payments are connected with the business of the transferor and whether deduction would frustrate public policy. Consideration is also given to the tax treatment of the receipts from a strike insurance contract. Taxation of insurance companies offering strike insurance and reciprocal insurance funds as separate entities is not discussed.²

Some policies written by insurance companies provide indemnity for damage caused by riots at the inception of a strike, but exclude coverage for losses due to the interruption of business operations.³ Since these policies are essentially a form of casualty insurance, they are not considered in the following discussion.

I. FORMS OF STRIKE INSURANCE

There appear to be three possible variations in approach which might be contemplated by commercial enterprises seeking to avoid

¹ *Buffalo Forge Co. v. Mutual Security Co.*, 83 Conn. 393, 396, 76 Atl. 995, 996 (1910). Strike insurance cases decided during the early part of the century, however, did not involve tax questions, but rather interpretations of the language of insurance contracts and questions of waiver. See *Buffalo Forge Co. v. Mutual Security Co.*, *supra*; *Bowers & Kaufman v. Bothwell*, 152 Md. 392, 136 Atl. 892 (1927); *Fleet-McGinley Co. v. Bothwell*, 143 Md. 324, 122 Atl. 195 (1923); *Standard Printing & Publishing Co. v. Bothwell*, 143 Md. 303, 122 Atl. 202 (1923).

² See generally INT. REV. CODE OF 1954, §§ 501(c)(15), 821(b); Treas. Reg. § 1.501(c)(15)-1 (1958); Treas. Reg. § 1.821-1 (1956); Treas. Reg. § 1.6012-2(c)(2) (1958).

³ See *Port Murray Dairy Co. v. Providence Washington Ins. Co.*, 52 N.J. Super. 350, 145 A.2d 504 (1958); *Ford Motor Co. v. Prudential Assur. Co.*, [1959] Can. Sup. Ct. 539, 18 D.L.R.2d 273 (1959).

the risk of the immediate loss of revenue that occurs because of a strike. First, an enterprise might enter into an insurance contract with an underwriter whose primary business is insurance, such as a stock or mutual insurance corporation or a syndicate of underwriters operating through the Lloyd's of London insurance exchange. Second, commercial enterprises may seek to spread the expense caused by strikes among themselves by making payments to a reciprocal insurance fund. Reciprocal insurance is a system whereby individuals, partnerships, or corporations engaged in a similar line of business indemnify each other against certain kinds of losses by way of a mutual exchange of insurance contracts. Usually the exchange is through a common attorney-in-fact appointed by each member under agreements whereby each separately becomes both an insured and insurer with several liability only.⁴ The reciprocal arrangement, including the insurance fund, is not a corporation or a partnership although the members and attorney-in-fact may be incorporated.⁵ Third, enterprises within an industry might agree that when one or more firms are struck, the companies not the target of the strike would make certain payments directly to the struck firm.

Newspaper publishers have developed a plan that fits into the first category, and approximately four hundred daily newspapers have participated for over ten years. The strike insurance is written by an unidentified company. The underwriter, however, is represented by Lloyd's attorneys in the United States. The premium payments vary in proportion to the amount of indemnity; they are fixed, however, in the sense that they are not subject to any additional assessment. To be eligible for indemnity payments, a publisher usually must offer to arbitrate the strike issues. The employers need not, however, offer arbitration when the strike concerns any of the following issues except where the issue is provided for in the existing labor agreement: news and editorial policy, assignment of editors, reporters, or writers, pension or welfare plans, or union or closed shop agreements. Payments start on the eighth day after the work stoppage begins and continue for varying periods up to a maximum of one hundred days depending on the size of the premium. The amount of the

⁴ 2 COUCH, *INSURANCE* § 18.11 (2d ed. 1959). See L.O. 1063, 2 CUM. BULL. 272 (1921).

⁵ MEHR & CAMMACK, *PRINCIPLES OF INSURANCE* 60 (3d ed. 1961).

proceeds also varies, but the maximum is ten thousand dollars per day.⁶

Ten major airlines are parties to an arrangement begun in October 1958, which clearly fits into the third category, the direct payments classification. There is no pre-determined premium and no middleman insurer. Unstruck airlines pay to a grounded carrier their increased revenues attributable to a strike, minus their extra direct expenses. The mutual assistance agreement is operative during strikes called to enforce union demands in excess of the recommendations of an emergency board established by the President of the United States under section 10⁷ of the Railway Labor Act,⁸ or which do not involve an emergency board if the struck carrier has complied with the procedures of the Railway Labor Act. Strikes called before the employees have exhausted the procedures of that act, or which are otherwise unlawful, also bring the plan into operation.⁹

The railroads, however, have a strike insurance arrangement that is formally within the first category (typical insurance underwriter contracts), but could be viewed as substantively within the second (reciprocal) or the third (direct payments) category. The plan, instituted in August 1959, now has nearly two hundred railroads, handling over ninety-nine percent of the freight-ton and passenger miles in the United States, participating. Each railroad has an insurance policy issued by the Imperial Insurance Com-

⁶ Confidential informal materials issued by persons closely connected with the newspaper plan; AFL-CIO American Federationist, March 1961, p. 17; 190 NATION 249 (1960); N.Y. Times, Sept. 9, 1960, p. 10, col. 1.

⁷ 44 Stat. 586 (1926), as amended, 48 Stat. 1197 (1934), 45 U.S.C. § 160 (1958).

⁸ 44 Stat. 577 (1926), as amended, 45 U.S.C. §§ 151-88 (1958).

⁹ Six Carrier Mutual Aid Pact, Docket No. 9977, C.A.B. Order No. E-13899, May 20, 1959, 1959 AV. L. REP. ¶ 22269, 27 U.S.L. WEEK 2594 (May 26, 1959), *aff'd on reconsideration*, C.A.B. Order No. E-14563, Oct. 19, 1959, 1959 AV. L. REP. ¶ 22317; Composite Mutual Aid Agreement as Amended, Nov. 23, 1960; N.Y. Times, Sept. 9, 1960, p. 10, col. 1. The sugar plantations in Hawaii have an agreement which is similar to the airlines plan in that members of the industry make payments directly to each other. Losses in revenue during the year of a strike are not compensated, but losses in the six following years are covered. The plan operates in this way because cane is allowed to grow two years before harvesting. Lack of care during a strike may cause a dislocation of planting and harvesting schedules for many years. Each of the participating plantations has agreed on a normal production figure. After the strike year, the first one-third of "normal" production for each is excluded from coverage. Seventy-five percent of the losses beyond this point are compensated. The plan is similar to a deductible insurance policy; it is intended to indemnify only in the event of a catastrophe. Bus. Week, June 28, 1958, p. 95.

pany, Ltd., Nassau, the Bahamas, a capital stock corporation.¹⁰ Strikes covered by the agreement include those contrary to the provisions of the Railway Labor Act, strikes to enforce demands contrary to the recommendations of an emergency board appointed by the President, strikes to secure demands that affect railroads representing more than fifty percent of the aggregate indemnity of all insured railroads provided that an emergency board has not been appointed or, if appointed, has failed to make definite recommendations. If more than fifty percent of the aggregate indemnity of all roads becomes due on one day, however, no indemnity payments are to be made. The policy indemnifies a railroad for its fixed expenses as determined by the insured railroad at the time of contracting. There is no indemnity for variable expenses or lost profits. An initial premium is charged to pay for the insurance company's administrative expenses. At the time a policy is issued, a railroad is also required to deposit an amount equal to one day's indemnity in a Nassau bank. The insurer may draw on this amount in the event that later required payments are not made. When a strike actually occurs the insurance company calls for payments from each non-struck carrier in amounts proportional to the daily indemnity of each railroad. The middleman insurer used by the railroads, moreover, is not a typical insurance corporation. It has no offices apart from its right to use the facilities of a Nassau bank. The company employs no permanent clerical staff and has no telephone listed in its own name. Additionally, the heads of three regional railroad organizations form an advisory committee to approve claims against the insurer, Imperial Insurance.¹¹ With regard to the premiums, then, the railroad plan might be said to be in substance a mutual assistance contract such as the airlines arrangement, or possibly a form of reciprocal insurance.

II. DEDUCTIBILITY

Deductibility of the cost, or "premiums," of strike insurance is, of course, governed by section 162 (a) of the Internal Revenue

¹⁰ Lloyd's of London has denied that it has any connection with the company. N.Y. Times, Sept. 10, 1960, p. 24, col. 1.

¹¹ Jointly prepared record of proceedings and brief for plaintiff, *Kennedy v. Long Island R.R.*, Civ. No. 60-3496, S.D.N.Y.; *Bus. Week*, Sept. 24, 1960, p. 28; *Nation's Bus.*, July 1960, pp. 76, 78; *National Underwriter*, Nov. 13, 1959, p. 2; N.Y. Times, Sept. 9, 1960, p. 10, cols. 1, 5; N.Y. Times, July 14, 1959, p. 20, col. 4; *Wall St. J.*, July 13, 1959, p. 1, col. 6.

Code of 1954 which provides for the deduction from gross income of "all the ordinary and necessary expenses paid . . . in carrying on any trade or business"¹²

A. *Ordinary, Necessary, and Reasonable*

A business expense is ordinary if persons in similar circumstances make the same kind of expenditures.¹³ The Supreme Court has said that "it is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling."¹⁴ Even though an expense is unique in the life of a taxpayer, it is ordinary as long as it is not unique "in the life of the group, the community of which he is a part."¹⁵ All payments made under the existing strike insurance arrangements would be ordinary under these standards because numerous companies in the same line of commerce make similar expenditures. At present, the character of strike insurance expense is the same for all members of an industry except for the variation in the amount of the payments.

Expenses must be necessary, as well as ordinary, in order to qualify for deduction. An expense need not be necessary in the sense that it is indispensable; it must, however, be appropriate and helpful to the taxpayer's business. The taxpayer's judgment that expenses are necessary usually will prevail.¹⁶

It is well established that payments made to an association which seeks to avoid labor disputes or to solve them rapidly are deductible as an ordinary and necessary business expense.¹⁷ "Pre-

¹² INT. REV. CODE OF 1954, § 162(a).

¹³ *Amtorg Trading Corp. v. Commissioner*, 65 F.2d 583, 586 (2d Cir. 1933).

¹⁴ *Deputy v. du Pont*, 308 U.S. 488, 496 (1939). In one insurance case, the Board of Tax Appeals held that the premiums in question were neither ordinary, nor necessary. The main thrust of the opinion, however, is that the payments were not ordinary because there was no evidence in the record that the same expenditures had been made by any other person in the same business when confronted with similar conditions. *Herman Goedel*, 39 B.T.A. 1 (1939).

¹⁵ *Welch v. Helvering*, 290 U.S. 111, 114 (1933).

¹⁶ *Id.* at 113.

¹⁷ *Fritz B. Campen*, 16 B.T.A. 543 (1929), *acq.*, VIII-2 CUM. BULL. 9 (1929); *Simons Brick Co.*, 14 B.T.A. 878 (1928), *acq. this issue*, VIII-2 CUM. BULL. 48 (1929), *aff'd on other issues*, 45 F.2d 57 (9th Cir. 1930), *cert. denied*, 283 U.S. 834 (1931); *Sam H. Harris*, 11 B.T.A. 871 (1928), *acq.*, VII-2 CUM. BULL. 17 (1928); *George M. Cohan*, 11 B.T.A. 743 (1928), *aff'd on other issues*, 39 F.2d 540 (2d Cir. 1930); *H. A. Allen*, 7 B.T.A. 1256 (1927), *acq.*, VII-1 CUM. BULL. 1 (1928); *Richmond Hosiery Mills*, 6 B.T.A. 1247 (1927), *acq.*, VI-2 CUM. BULL. 6 (1927), *aff'd on other issue*, 29 F.2d 262 (5th Cir. 1928), *cert. denied*, 279 U.S. 844 (1929); *California Brewing Ass'n*, 5 B.T.A. 347 (1926), *acq. this issue*, VII-1 CUM. BULL. 5 (1928).

miums" paid in connection with a strike insurance arrangement reasonably can be expected to prevent or shorten strikes suffered by the contributor because the "premiums" entitle it to receive payments in the event of a strike, and labor unions ought to be less willing to undertake or continue a strike if they know that its economic pressure will be weakened by these outside payments. Thus, strike insurance "premiums," like expenditures to associations which try to solve labor problems, are designed to prevent or alleviate the financial loss that would otherwise result from a strike.¹⁸ Both types of payments, then, serve to accomplish common purposes. They ought to be considered equally appropriate and helpful to a business.

Two of the association-payment cases seem to have special significance in the area of strike insurance. *George M. Cohan*¹⁹ and the companion case of *Sam H. Harris*²⁰ involved a firm that was a member of a theatrical producers' association. When the association failed to avert an actors' strike, it assessed its members to raise a fund to pay counsel fees, for publicity, police protection, and "to finance the small producers who could not afford to be inactive during the period the strike continued."²¹ The Board of Tax Appeals, in both cases, held that the payments were necessary to the businesses of the contributing producers. Since strike insurance payments always have as an end result the financing of a company during a strike, *Cohan* and *Harris* might be considered direct authority for the proposition that the expense of strike insurance is "necessary." And it would seem that any member of an industry has a business interest in the collective bargaining settlement of the first employer to sign a new contract in a period of general re-negotiation, especially where pattern bargaining

¹⁸ An employer, however, may be reluctant to make this argument in tax litigation. If a strike took place later a union could argue that the employer has admitted stalling tactics. Stalling may constitute a breach of the obligation to bargain in good faith imposed by §§ 8 (a) (5) and 8 (d) of the National Labor Relations Act, 61 Stat. 141 (1947), 29 U.S.C. §§ 158 (a) (5), 158 (d) (1958). See *NLRB v. National Shoes, Inc.*, 208 F.2d 688 (2d Cir. 1953); *Stanislaus Implement & Hardware Co.*, 101 N.L.R.B. 394 (1952), enforced, 226 F.2d 377 (9th Cir. 1955). The Railway Labor Act, § 2, First & Second, 48 Stat. 1187 (1934), 45 U.S.C. § 152, First & Second (1958), imposes an obligation to bargain in good faith on railroads and airlines, 49 Stat. 1189 (1936), 45 U.S.C. § 181 (1958). § 2, Second, of the Railway Labor Act directs that, if possible, disputes be decided "with all expedition."

¹⁹ 11 B.T.A. 743 (1928), *aff'd on other issues*, 39 F.2d 540 (2d Cir. 1930).

²⁰ 11 B.T.A. 871 (1928), *acq.*, VII-2 CUM. BULL. 17 (1929).

²¹ 11 B.T.A. at 748; 11 B.T.A. at 872. (Emphasis added.)

prevails. Although the Commissioner of Internal Revenue acquiesced in the *Harris* decision,²² this authority should be viewed with some caution. Subsidizing struck producers was only one of the purposes of making the payments in question. In addition, over thirty years have elapsed since the date of decision and the same issue has never been raised in any other litigation. The issue here in question was not relitigated in the appeal from the *Cohan* decision which is well-known for another reason.²³

The decision of the Sixth Circuit in *Commissioner v. Lincoln Electric Co.*²⁴ poses an additional problem. Even though the introductory general provision of section 162 (a) contains no express requirement of reasonableness, that case holds that the expense must be reasonable in amount. The taxpayer involved made payments on an employee's annuity policy. The court held that the payments were not compensation within the scope of the subsection of 162 (a) specifically allowing deduction of compensation for personal services to the extent that the payments are a "reasonable allowance."²⁵ Nevertheless, the court found that an element of reasonableness inheres in "ordinary and necessary." The court said, "Clearly it was not the intention of Congress to automatically allow as deductions operating expenses incurred or paid by the taxpayer in an unlimited amount."²⁶ The opinion seems to be concerned with the situation where a business taxpayer does not receive full or substantial value for the money. The justice of a reasonableness requirement when there is no close relationship between the taxpayer and the transferee receiving an expenditure is debatable, and the *Lincoln Electric* decision has been criticized severely.²⁷

Arguably, premiums for insurance of all kinds could be considered per se unreasonable if there is no return because no occasion for indemnity arises. In the law of contracts, however,

²² VII-2 CUM. BULL. 17 (1929).

²³ *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930). The Second Circuit held that absolute certainty of expenses is not required of the taxpayer. A court should make as close an approximation as possible.

²⁴ 176 F.2d 815 (6th Cir. 1949).

²⁵ INT. REV. CODE OF 1954, § 162 (a) (1) [formerly Int. Rev. Code of 1939, ch. 247 § 23 (a) (1)].

²⁶ 176 F.2d at 817.

²⁷ See Peters, *The Lincoln Electric Company Case*, 4 MIAMI L.Q. 12 (1949); Killcullen, *Is Reasonableness a Requirement of Non-Compensation Expenses?*, N.Y.U. 9TH INST. ON FED. TAX. 863 (1951); Comment, 49 MICH. L. REV. 395 (1951).

an insurance agreement is analyzed as an aleatory contract. There is no equality of the payments that are promised, but they do not constitute the agreed exchange; the exchange of consideration is found in the promise to pay a certain premium on the part of the insured and the assumption of the risk of paying a certain sum on the part of the insurer.²⁸ Insofar as strike insurance "premiums" are to be subjected to a test of reasonableness of amount, then, the primary factor should be whether the premiums paid bear a rational relationship to the risk assumed. Premiums under the newspaper plan vary from 123 dollars for each one hundred dollars of indemnity per day up to twenty-five days, to 203 dollars for each one hundred dollars of indemnity up to one hundred days.²⁹ These ratios hardly seem unreasonable. Because the premium and indemnity amounts are fixed, a newspaper can purchase strike insurance knowing that deduction of the premiums will not be barred because they are unreasonable in amount. On the other hand, the premiums paid by railroads holding strike insurance are determined on an *ad hoc* basis and are subject to variation because of events outside the control of any particular railroad. A railroad, then, cannot be sure that the premiums it pays will bear a reasonable relationship to its indemnity coverage during a particular year until the end of that year when the premiums actually paid can be compared with the indemnity coverage during the year. Additionally, only a high ceiling is placed on the amount of premium payments that may be required. The contract provides that they may be as large as twenty days' fixed expenses.³⁰ In September 1960, for example, the New Haven Railroad made payments of 100,000 dollars per week to Imperial Insurance because of the Pennsylvania Railroad strike.³¹ The problem is even more difficult with respect to the airlines plan. Here there is no definite risk assumed by anyone. Because the indemnity is based on the application of a formula to profits earned by non-struck carriers, not even at the end of a particular year could the "premiums" actually paid by a carrier which had not suffered a strike during the year be compared with any certain indemnity amount. The airlines agreement went into effect

²⁸ See SIMPSON, *CONTRACTS*, § 119 (1954).

²⁹ Authorities cited note 6 *supra*.

³⁰ Authorities cited note 11 *supra*.

³¹ N.Y. Times, Sept. 10, 1960, p. 1, col. 1.

during an upsurge of labor trouble. The extreme situation is represented by United Airlines. It made payments of four million dollars in slightly less than the first two years of the plan's operation without any occasion arising in which it was entitled to receive indemnity payments from other carriers.³² Still, because it is apparent that the risk insured by the railroad and airlines strike insurance plans is tremendous, whatever "premiums" are actually paid should be considered reasonable without any showing of the precise premium-indemnity ratio. Moreover, the very existence of a strike insurance plan may be the reason why a particular insured party suffers no strike. This factor, which is probably absent in arrangements for insuring against other common risks, is an additional reason for considering the railroad and airlines "premiums" reasonable in amount without any examination of the actual premium-indemnity ratio.

B. *Connection with Business*

An additional test with regard to deducting a "trade or business" expense under section 162 (a) is whether the taxpayer made the expenditure for *his* business. An expense must be directly connected with or proximately result from the business of the taxpayer.³³ In *Deputy v. du Pont*,³⁴ the taxpayer held stock in the du Pont company. For business reasons, the company thought it desirable for certain executives to have a financial interest in the company. Since legal difficulties stood in the way of the company selling the desired number of shares to the executives, the taxpayer-stockholder undertook to make the sale. The taxpayer did not have readily available the number of shares needed, but he borrowed some and agreed to pay the lender the equivalent of all dividends declared and paid on the shares. The taxpayer sought to deduct his expenditures as expenses of the business of conserving and enhancing his estate. The Supreme Court held that these expenses were not deductible on the ground, *inter alia*,³⁵ that the transaction out of which the carrying charges arose was not within

³² AFL-CIO American Federationist, March, 1961, pp. 17, 19.

³³ *Kornhauser v. United States*, 276 U.S. 145, 153 (1928).

³⁴ 308 U.S. 488 (1940).

³⁵ The holding was also based on the ground that the payments were not ordinary. Mr. Justice Roberts, dissenting, thought that the decision rested only on this ground. 308 U.S. at 500-01.

the taxpayer's business even though it might benefit the taxpayer by improving his investment in the du Pont company. The expense, rather, was an expense of the du Pont company.

In one sense, *all* insurance premiums present a *du Pont* problem because a premium usually pays for an expense of another business. However, the Treasury Regulations provide that business expenses include: "Insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business" ³⁶ Apparently the *du Pont* reasoning is not applied to insurance, at least in a typical situation. Perhaps this is because premium payments *may* redound to the benefit of the contributor in an amount greater than the size of the premium, although they are most likely, as far as each contributor is concerned, to benefit directly another business. ³⁷ The situation, then, is similar to that in the cases involving payments or dues to an association that deals with labor problems when the money may be used to assist other members of the association. ³⁸ The value of the benefit received may vary from nothing to an amount substantially greater than the contribution.

Because an insurance contract with an underwriter whose primary business is insurance, such as a stock or mutual insurance corporation or a syndicate of Lloyd's underwriters, is the most widely used method of insurance, the language of the regulations implies that the *du Pont* principle does not apply to premiums paid pursuant to such an arrangement. *Du Pont*, then, ought not to apply to the newspaper plan. Moreover, the fact that ordinary insurance premiums are subject to a retrospective increase in amount should not vitiate deductibility. ³⁹ Looking only at the form of the railroad insurance arrangement, *du Pont* would have no application.

Commercial enterprises which spread the expense caused by

³⁶ Treas. Reg. §§ 1.162-1 (a) (1958).

³⁷ In the *Cohan* opinion, the Board of Tax Appeals said that the payments had a "direct relation to the business." 11 B.T.A. at 760. But insofar as the payments in that case were to subsidize struck producers, they were made to pay expenses of another business and without any possibility of a similar benefit to the contributor.

³⁸ The Board of Tax Appeals stated in an early case involving payments to an association which dealt with labor problems that the expenditure was "directly connected with the business" of the taxpayer. *Richmond Hosiery Mills*, 6 B.T.A. 1247, 1255 (1927).

³⁹ See *Midwest Motor Express, Inc.*, 27 T.C. 167 (1956), *aff'd on other issue*, 251 F.2d 405 (8th Cir. 1958).

strikes among themselves by making payments to a reciprocal insurance fund probably would not be attacked on the basis of *du Pont*. In a Revenue Ruling, the Commissioner permitted deduction of annual payments to a reciprocal insurance fund.⁴⁰ It should be noted, however, that in that ruling the indemnity payments were made from the reciprocal fund, and were not supplemented by *ad hoc* payments from uninjured parties when an occasion arose calling for indemnity of one party. Thus, if the railroad agreement were determined to be in substance a reciprocal insurance fund, this precedent would not preclude application of the *du Pont* principle. If a retrospective increase in premium payable to an underwriter is deductible, however, an *ad hoc* premium payable to a reciprocal insurance fund ought to receive the same treatment.

Because of the peculiar nature of strike insurance, however, it may not be considered a typical insurance situation either in a particular industry or in a particular fact situation—even where the form of the insurance arrangement might be considered typical. This view should be anticipated when an industry-wide union regularly sets the pattern for wage scales in the industry by threatening to strike an employer who is in a weak position to withstand the economic pressure of a strike. It might be argued that, although the form of insurance was typical, the strike insurance “premiums” paid by a strong member of such an industry should be viewed merely as expenditures which pay the strike expenses of the weak members.

If enterprises within an industry agree that when one firm is struck, the non-struck companies are to make payments directly to the struck firm, the situation is distinguishable from the more typical insurance arrangements discussed above because of the ab-

⁴⁰ Rev. Rul. 55-189, 1955-1 CUM. BULL. 265. Rev. Rul. 60-275, 1960-2 CUM. BULL. 43, however, tested the deductibility of withdrawable premiums paid to a reciprocal insurance fund. The contributors were to be indemnified for losses due to floods in proportion to the size of the premiums paid. The Internal Revenue Service took the position that all contributors would have to be indemnified in the event of a flood because they were located in the same geographical area. Because premiums, in effect, would be passed back to the original contributor, the premiums were said to constitute a nondeductible reserve for self-insurance. The fact that a self-insurance fund is administered by an independent agent does not make contributions deductible. *Spring Canyon Coal Co. v. Commissioner*, 43 F.2d 78 (10th Cir. 1930), *cert. denied*, 284 U.S. 654 (1931). The self-insurance problem could be avoided with regard to a reciprocal strike insurance fund by providing that no indemnity payments will be made if all participants are struck at the same time.

sence of any middleman between the insured companies. Because the payments in the airlines plan are made directly from the non-struck carrier to the struck airline, the application of *du Pont* is more likely on the ground that the "premiums" are directly connected with shortening a strike of the recipient airline. Strikes by employees of a particular airline are discouraged only by the promise of other airlines to pay sums to the airline in question in the event that it suffers a strike. If the railroad plan is viewed as, in substance, a mutual assistance contract essentially similar to the airlines agreement, the same problem arises.

Payments to a struck firm by parties to a mutual assistance contract, nevertheless, should be held to be directly connected with the contributor's business for two reasons. First, non-affiliated companies have been permitted to deduct payments made pursuant to a contract in which the more profitable parties agreed to contribute the excess of certain earnings to the less profitable parties. The payments were found to be directly connected with the business on the ground that the pooling agreement was ancillary to a contract providing for mutual aid in securing business contracts.⁴¹ A mutual assistance agreement to avoid losses due to strikes has a business purpose and, hence, is analogous to the pooling agreement. An airline, however, probably would be reluctant to argue that the plan is, in effect, a pooling of profits because that would tend to establish an admission that the plan contravenes the policy of the antitrust laws.⁴² Moreover, a railroad might fear this argument as an admission that its plan is in violation of the Interstate Commerce Act proscription of pooling assets without permission of the ICC.⁴³ Second, if a mutual assistance contract is in sub-

⁴¹ S.M. 5523, V-1 CUM. BULL. 227 (1926). Compare *Traylor Eng'r & Mfg. Co. v. Lederer*, 271 Fed. 399 (3d Cir. 1921), *cert. denied*, 257 U.S. 638 (1921); *Moxa Bldg. Co.*, 31 B.T.A. 457 (1934).

⁴² The agreement, like the present airline mutual assistance pact, must be filed with the Civil Aeronautics Board. The CAB approves an agreement only if it is in the public interest. Federal Aviation Act of 1958, § 412, 72 Stat. 770 (1958), 49 U.S.C. § 1382 (1958). The public interest requires maintenance of competition. Federal Aviation Act of 1958, § 102, 72 Stat. 740, 49 U.S.C. § 1302(d) (1958). The anti-trust laws are one factor considered. *Local Cartage Agreement Case*, 15 C.A.B. 850, 853 (1952). Agreements outside this context for the pooling of profits have been held in violation of the Sherman Act, § 1, 50 Stat. 693 (1937), as amended, 15 U.S.C. § 1 (1958). See *Lee Line Steamers, Inc. v. Memphis, H. & R. Packet Co.*, 277 Fed. 5 (6th Cir. 1922); *Delaware, L. & W. R.R. v. Frank*, 110 Fed. 689 (C.C.W.D.N.Y. 1901).

⁴³ See Interstate Commerce Act § 5(1), 54 Stat. 905 (1940), 49 U.S.C. § 5(1) (1958). See generally Brief for plaintiff, *Kennedy v. Long Island R.R.*, Civ. No. 60-3496, S.D.N.Y.; *Walker, Pooling by Carriers*, 15 I.C.C. PRAC. J. 282 (1948).

stance an insurance contract, the cost should receive the same tax treatment as typical insurance premiums. Both the railroad and airlines plan are in substance an insurance agreement.⁴⁴ They both involve a shifting and distribution of risk, the main characteristics of insurance according to the Supreme Court.⁴⁵ Taxpayers, after all, may utilize the doctrine of substance over form⁴⁶ even though the Commissioner is its usual proponent.⁴⁷

C. *Public Policy*

Another problem stems from the fact that the legality of strike insurance is not entirely certain. A rule developed by the judiciary prohibits deduction of payments as ordinary and necessary expenses if allowing them would frustrate a sharply defined policy of national or state government. The bar to deductibility is not limited to fines, but extends to private transactions in which payments are illegal. While emphasis is placed on the peculiar facts of each case, the test of nondeductibility is the severity and immediacy of the frustration resulting from the allowance of a deduction.⁴⁸ A remote relation of an expenditure to an illegal act, however, will not result in nondeductibility.⁴⁹

1. *Legality of Strike Insurance*

Doing business by offering or writing strike insurance has been declared informally to be contrary to the policy of the State of New York. On August 2, 1956, Jacob Javits, then Attorney General of New York, stated to a newspaper union that he had been advised by the Insurance Department that applications for licenses⁵⁰ to write strike insurance had been rejected on the ground that approval of such coverage would be "contrary to public policy."⁵¹ New York defines insurance broadly enough to include reciprocal insurance and a mutual assistance plan, as well as a

⁴⁴ Cf. Joseph Nussbaum, 19 B.T.A. 868 (1930).

⁴⁵ Helvering v. LeGierse, 312 U.S. 531, 539 (1941).

⁴⁶ E.g., Pressed Steel Car Co., 20 T.C. 198 (1953).

⁴⁷ See, e.g., Gregory v. Helvering, 293 U.S. 465 (1935).

⁴⁸ Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958); Lilly v. Commissioner, 343 U.S. 90 (1952).

⁴⁹ Commissioner v. Sullivan, 356 U.S. 27, 29 (1958); Commissioner v. Heininger, 320 U.S. 467, 474 (1943).

⁵⁰ See generally N.Y. Ins. Law §§ 40-45.

⁵¹ 190 NATION 249, 250 (1960); Editor & Publisher, Aug. 18, 1956, p. 66.

typical insurance arrangement with a stock or mutual insurance corporation or an individual underwriter.⁵² The New York Insurance Law provides authorization for the writing of only certain types of insurance. Strike insurance does not fit within any of the categories in section 46, the authorizing provision.⁵³ It should be noted, however, that the penalties for violating section 46 would apply only to insurers and those acting in their behalf.⁵⁴ In a reciprocal insurance exchange or a mutual assistance agreement, however, each member is an insurer as well as an insured party and, thereby, would seem to be subject to the penalties imposed for violation of the statute.

Strike insurance also may be contrary to federal legislation. An airlines agreement substantially the same as the present plan⁵⁵ was tested in *Six Mutual Aid Pact*,⁵⁶ decided by the Civil Aeronautics Board in 1959. The plan was approved except for a provision which required the struck airlines to direct traffic to other non-struck signatories. Jurisdiction was based on section 412 of the Federal Aviation Act of 1958⁵⁷ which requires every air carrier to submit any agreement affecting air transportation to the Board. The Board is required to disapprove all agreements that it finds to be adverse to the public interest and to approve all that are not.⁵⁸ In *Six Mutual Aid Pact* the Board looked to other federal

⁵² See N.Y. INS. LAW §§ 41, 410, 425.

⁵³ N.Y. INS. LAW § 46. Insurance for damage to property caused by riots at the inception of a strike probably would be permitted by the statute. See N.Y. INS. LAW § 46(14).

⁵⁴ See *Akers v. Mutual Life Ins. Co.*, 59 Misc. 273, 112 N.Y. Supp. 254 (Sup. Ct. 1908). An insurance policy in violation of statutory provisions, moreover, is binding upon the insurer. See N.Y. INS. LAW § 143(1).

⁵⁵ The airlines agreement was expanded in March 1960 to include four more carriers. The plan was revised to include strikes in which the President does not find it necessary to appoint an emergency board, provided that the struck carrier has complied with the procedures of the Railway Labor Act. The unions have asked the CAB to disapprove the expanded agreement on the theory that the plan is now applicable to all strikes and extends beyond what the airlines justified when the CAB approved the plan originally. See *Six Carrier Mutual Aid Pact*, Docket No. 9977, C.A.B. Order No. E-13899, May 20, 1959, 1959 AV. L. REP. ¶ 22269, 27 U.S.L. WEEK 2594 (May 26, 1959), *aff'd on reconsideration*, C.A.B. Order No. E-14563, Oct. 19, 1959, 1959 AV. L. REP. ¶ 22317. The CAB has ordered new hearings (Order No. E-15413). *Nation's Bus.*, July 1960, p. 76; *N.Y. Times*, April 13, 1960, p. 78, col. 6.

⁵⁶ Note 55 *supra*. Commentaries have thoroughly explored and questioned the decision. See Wischart, *The Airlines' Recent Experience Under the Railway Labor Act*, 25 LAW & CONTEMP. PROB. 22, 37-40 (1960); Comment, 60 COLUM. L. REV. 205 (1960); Note, 35 IND. L.J. 491 (1960).

⁵⁷ 72 Stat. 770 (1958), 49 U.S.C. § 1382(a) (1958).

⁵⁸ 72 Stat. 770 (1958), 49 U.S.C. § 1382(b) (1958).

legislation, as well as other sections of the act in considering the public interest. Three contentions that the plan was contrary to the Railway Labor Act were rejected. It was argued that the agreement repudiated the act's requirement that collective bargaining be in good faith,⁵⁹ brought into a labor dispute air carriers which were not proper parties,⁶⁰ and forced unions to accept recommendations of a presidential emergency board. Moreover, the Federal Aviation Act specifically provides that it is in the public interest to have "competition to the extent necessary to assure the sound development"⁶¹ of the industry. The Board decided that the agreement arose from business requirements, that there was no intent to monopolize, and that there would be no substantial lessening of competition. On the other hand, the provision of the agreement restricting direction of traffic was ordered deleted on the ground that it was repugnant to established antitrust principles. The Board also rejected contentions that the plan violates section 102 of the Federal Aviation Act of 1958.⁶² According to the Board, this section requires it to guard the public interest in stability and efficiency of air transportation that freedom from labor strife provides.⁶³

The railroad strike insurance plan is in the process of attack in litigation before the federal district court for the Southern District of New York in the case of *Kennedy v. Long Island R.R.*⁶⁴ The Brotherhood of Railroad Trainmen brought the suit against several railroads and the Association of American Railroads. The suit has been brought as a class action to recover damages resulting from a twenty-six day strike of the Long Island beginning in July 1960.⁶⁵ The plaintiffs offer five arguments:⁶⁶ (1) the Long Island Rail Road's participation in the strike insurance plan was a violation of its duty to bargain in good faith; (2) the Long Island

⁵⁹ 48 Stat. 1187 (1934), 45 U.S.C. § 152, First & Second (1958).

⁶⁰ See 48 Stat. 1187 (1934), 45 U.S.C. § 152, Second (1958).

⁶¹ 72 Stat. 740 (1958), 49 U.S.C. § 1302(d) (1958).

⁶² 72 Stat. 740 (1958), 49 U.S.C. § 1302 (1958).

⁶³ The Board also rejected the argument that the subsidy mail pay program under § 406 of the Federal Aviation Act of 1958, 72 Stat. 763, 49 U.S.C. § 1376 (1958), would cause federal funds to be used to break a strike if a subsidized carrier became a party to the agreement. The Board disposed of this contention on the ground that it was premature because no subsidized carrier was currently a party to the agreement.

⁶⁴ Civ. No. 60-3496, S.D.N.Y.

⁶⁵ See jointly prepared record of proceedings, *Kennedy v. Long Island R.R. Co.*, *supra* note 64.

⁶⁶ See Brief for plaintiff, *ibid.*

introduced an element of multi-party bargaining without the consent of the plaintiffs; (3) the defendants other than the Long Island conspired to and tortiously interfered with the plaintiff's statutory collective bargaining rights and induced a violation of these rights by the Long Island; (4) the strike insurance plan is an illegal pooling of revenues by competing carriers without the permission of the Interstate Commerce Commission; (5) the strike insurance plan is an attempt to fix the price of railway labor which is a combination in restraint of trade prohibited by section 1 of the Sherman Act.⁶⁷

Some of the language of the Civil Aeronautics Board in *Six Mutual Aid Pact* supports the argument that the railroad plan contravenes the obligation of an employer to bargain in good faith. The Board's rejection of the argument that the airlines agreement repudiated the duty to bargain in good faith was in part based on a rejection of the argument that the operation of the plan would prolong the settlement of disputes. The Board said that, even though strikes were compensable under the agreement, they would continue to cause significant losses. In concluding that a struck airline would not be complacent about settlement the Board said: "It is noteworthy that payments under the agreement do not recoup a struck carrier's fixed costs, or its extraordinary expenses."⁶⁸ The recoupment of the struck carrier's fixed expenses, however, is exactly what the railroad agreement provides.

2. *Application of Public Policy Doctrine*

The issues that will determine the legality of strike insurance raised above suggest four problems that may arise with respect to the application of the rule against deducting payments that contravene public policy.

Declarations by Administrative Agencies. The first question is whether a determination by an administrative agency that a strike insurance plan is illegal involving discretion on the part of the administrative body would be a sufficient declaration of governmental policy to bar deductibility of payments that had been made under the insurance agreement.⁶⁹ The decisions indicate that there

⁶⁷ 50 Stat. 693 (1937), as amended, 69 Stat. 282 (1955), 15 U.S.C. § 1 (1958).

⁶⁸ 1959 Av. L. REP. ¶ 22269, p. 14479.

⁶⁹ While this problem is suggested by the submission of the airlines strike insurance plan (before amendment) to the Civil Aeronautics Board, it should be noted that the

is no general principle that would be applicable. Various factors have been emphasized in the decisions allowing deduction of administratively-determined compromise settlements for apparently illegal conduct and payments made in violation of regulations promulgated by administrative agencies. The courts have emphasized the insignificance of the amount,⁷⁰ the inadvertence of the taxpayer and precautions taken to avoid violation,⁷¹ the taxpayer's voluntary disclosure,⁷² sporadic enforcement of the regulation,⁷³ and approval by authorities in spite of a prohibitive regulation.⁷⁴ In denying deductions, the courts have noted that regulations clearly stated a rigid criterion of public policy,⁷⁵ that regulations of the administrative agency were given the full force and effect of law by a statutory provision,⁷⁶ and that there was a lack of evidence showing inadvertence and the taking of reasonable precautions to avoid illegal conduct.⁷⁷ Thus, there are some guides for a court to follow. None of those already enunciated, however, seem particularly appropriate to the strike insurance problem. It seems likely that deduction of strike insurance "premiums" that had been declared illegal by an administrative body exercising discretion would depend in large part on the imagination of counsel in presenting arguments that are appropriate to the character of the particular strike insurance arrangement and administrative ruling.

Absence of State Sanctions for Taxpayer. A second problem would arise in a situation where strike insurance is clearly not authorized by the law of a state applicable to a strike insurance contract or the insurer under the contract, but where the penalties imposed for violation of the statute apply only to the insurer and

plan always has provided for automatic termination in the event of disapproval by the Board so that, in any event, there would be no "premiums" paid after the administrative declaration of illegality. Composite Mutual Aid Agreement as Amended, Nov. 23, 1960.

⁷⁰ Farmers Creamery Co., 14 T.C. 879, 883 (1950) (amount was \$867.20).

⁷¹ National Brass Works, Inc. v. Commissioner, 182 F.2d 526 (9th Cir. 1950); Jerry Rossman Corp. v. Commissioner, 175 F.2d 711 (2d Cir. 1949); Pacific Mills, 17 T.C. 705 (1951). Compare Hoover Motor Express Co. v. United States, 356 U.S. 38 (1958); Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958).

⁷² Farmers Creamery Co., 14 T.C. 879, 883 (1950).

⁷³ See Polley v. Westover, 77 F. Supp. 973, 975 (S.D. Cal. 1948).

⁷⁴ Jack Dempsey's Punch Bowl, Inc., 11 T.C. 1030, 1034-36 (1948).

⁷⁵ See Weather-Seal Mfg. Co., 16 T.C. 1312, 1318 (1951) (alternative ground).

⁷⁶ Fred D. Newman, 21 P-H TAX CT. MEM. 809, 811 (1952), *relying on* Lovett v. State, 30 Ala. App. 334, 6 So. 2d 437 (1941), *interpreting* ALA. CODE tit. 29, § 52 (1940).

⁷⁷ Henry Watterson Hotel Co., 15 T.C. 902 (1950); Garibaldi & Cunco, 9 T.C. 446 (1947).

not to the insured. For example, if a New York company entered a strike insurance contract with a New York underwriter and no reciprocal insurance or mutual assistance arrangement was involved, the insured company would not be subject to penalties. Could the premiums paid by the insured be deducted as a business expense on the ground that public policy is not frustrated? Two arguments have been advanced for allowance of a deduction when the law imposes no sanctions on the taxpayer for a proscribed payment.⁷⁸ The legislature in such a case has not seen fit to punish the taxpayer at all, and it would be difficult to conclude that allowing a deduction would frustrate a specific legislative intent. Additionally, a rule denying deduction would tend to frustrate public policy by discouraging disclosure of the payments. There appears to be no authority in point.⁷⁹ Allowance of the deduction, however, is suggested by language of the Supreme Court in *Commissioner v. Heininger*.⁸⁰ In allowing a taxpayer to deduct the attorneys' fees he incurred in opposing a fraud order by the Postmaster General, the Court observed: "The single policy of these sections [of the statute permitting the order] is to protect the public from fraudulent practices committed through the use of the mails. It is not their policy to impose personal punishment on violators"⁸¹ Although the *Heininger* case is factually quite different from the case of proscribed payments for which there are no sanctions, the language suggests that deductibility is to be denied only when an aim of the governmental policy in question is to punish the taxpayer.

Application of State Law to Multi-State Agreements. Another problem which the Commissioner may face in determining whether a strike insurance agreement frustrates the public policy of a particular state is the extent to which the law of that state should be applied to situations in which the binding force of that law is called into question on the basis of conflict of laws rules or constitutional limitations. The problem is most likely to arise when a company desiring strike insurance is located in a state which proscribes the making of strike insurance agreements and

⁷⁸ See Note, 51 COLUM. L. REV. 752, 759 (1951).

⁷⁹ The existence of authority is implied in Note, 51 COLUM. L. REV. 752, 759, n.57 (1951), but the cases therein cited deal with the distinguishable problem of cost of goods sold.

⁸⁰ 320 U.S. 467 (1943).

⁸¹ *Id.* at 474.

the insurer is located outside the state. To put the problem in a more concrete context, assume that the insurer has not done any business within the hostile state; that the contract was negotiated and concluded in another state or foreign country which is not adverse to strike insurance; that the contract provides that all premiums will be paid and the contract otherwise performed outside the state; and that the parties intend that the law of the hospitable state or country should be applied to the contract. The power of a state to regulate and to apply its own law depends generally upon the substantiality of the contacts between it and the transaction involved, and in the situation posed the question of the application of the law of the hostile state can occur in three different conceptual settings: first, whether the hostile state may constitutionally regulate insurers whose principal operations are outside the state;⁸² second, whether the hostile state should apply its own law to a suit upon the strike insurance contract under conflict of laws rules;⁸³ and third, whether application of its own law to the contract would violate constitutional limitations.⁸⁴

The Supreme Court has not yet held that the hostile state would have the power to regulate the insurer or the performance of the contract in the situation posed.⁸⁵ Certiorari, however, recently has been granted in a case involving attempted regulation in a situation nearly identical to the facts of the hypothetical case suggested here.⁸⁶ In a 1943 opinion, *Hoopeston Canning Co. v. Cullen*,⁸⁷ the Supreme Court held that New York could regulate a foreign insurer who did not even enter into insurance contracts within New York; the basis for New York regulation

⁸² See generally 12 APPLEMAN, INSURANCE §§ 7071-95 (1943).

⁸³ See generally 19 APPLEMAN, INSURANCE §§ 10321-52 (1946).

⁸⁴ See generally Weintraub, *Due Process and Full Faith and Credit Limitations on a State's Choice of Law*, 44 IOWA L. REV. 449 (1959).

⁸⁵ Although looked upon with disfavor by the Supreme Court in recent decisions, the case of *Allgeyer v. Louisiana*, 165 U.S. 578 (1897), has not yet been overruled. In that case it was held unconstitutional for Louisiana to penalize the insured on an out-of-state insurance contract. The only contacts with Louisiana were that the property insured was temporarily within the state and the policyholder notified the insurer from that state.

⁸⁶ *State Bd. of Ins. v. Todd Shipyards Corp.*, 340 S.W.2d 339 (Tex. Ct. Civ. App. 1960), cert. granted, 368 U.S. 810 (1961). The State of Texas, pursuant to statute, taxed premiums paid on an insurance policy covering property located in the state. The property was used by its owner in doing business within the state. Texas had no other contacts with the insurance contract. The Court of Civil Appeals of Texas reluctantly held the tax unconstitutional.

⁸⁷ 318 U.S. 313 (1943). Compare *Osborn v. Ozlin*, 310 U.S. 53 (1940).

being that the insured property was located permanently within the state *and* that the insurer had been licensed to do business within the state in the past and its representatives entered the state to inspect the insured property. The language of *Hoopston* seems to go beyond its holding, but in any event it would be distinguishable from a strike insurance arrangement in which the only contact with the hostile state is the permanent location of the interest insured.

With regard to the conflict of laws problem and the constitutional limitations on a hostile state to apply its own law to invalidate a contract valid where entered, the language of a recent Supreme Court opinion suggests that liberal treatment will be given with respect to the number of contacts required. In *Watson v. Employers Liab. Assur. Corp.*⁸⁸ the state in which the user of a home permanent preparation was injured was permitted to apply its own statute allowing a direct action against the insurer despite a contrary clause in the seller's insurance contract which, in this case, had been entered and entirely performed in states permitting the agreement. Even in *Watson*, however, the insurer had an additional contact with the hostile state in that it was licensed and doing other business within the state. Even though there is a trend toward liberality in permitting application of the law of the forum to insurance contracts,⁸⁹ it is not clear at this point that the state's policy can constitutionally apply. If a hostile state's law is not applicable, deduction of course cannot properly be said to frustrate a policy of the state.

A different aspect of the same problem would be presented if a suit was brought on the hypothetical strike insurance contract suggested above in a court of the hostile state, and the court dismissed the action, as it may pursuant to the Constitution,⁹⁰ not because its internal law is applicable, but because the contract is contrary to its public policy. In this situation the contract is not illegal or unenforceable in the sense that it is proscribed by applicable law. The hostile state is merely unwilling to lend its courts to enforcement of the contract. The absence of a direct ap-

⁸⁸ 348 U.S. 66 (1954). Compare *Hartford Acc. & Indemn. Co. v. Delta & Pine Land Co.*, 292 U.S. 143 (1934); *Home Ins. Co. v. Dick*, 281 U.S. 397 (1930).

⁸⁹ See generally Lenhoff, *Conflict Avoidance in Insurance*, 21 LAW & CONTEMP. PROB. 549 (1956), 1957 INS. L.J. 101.

⁹⁰ *Griffin v. McCoach*, 313 U.S. 498 (1941).

plication of the hostile law to the contract and the lack of any penalty or damages when an action is dismissed provide arguments for allowing deduction of the premiums. This problem, of course, could be avoided entirely if the parties litigated any questions arising under the contract in a non-hostile state.

In any event, since there is no Supreme Court authority for the proposition that the hostile state may regulate the insurer or apply its own law to the contract in the strike insurance arrangement posed hypothetically, the premiums paid should not be subject to the rule against deducting expenses that are contrary to public policy.

Problems arising from the conflict of laws rule applicable to strike insurance contracts are likely to be of more than theoretical relevance. The railroads are utilizing a foreign insurance company, one located in Nassau, the Bahamas.⁹¹ The newspaper publishers may be using a foreign insurer as well since premiums are paid by the insured newspapers to the Montreal Trust Company in escrow for the unidentified insurer.⁹² The airlines plan, of course, involves no payments to an insurance company or fund.

Unsettled Public Policy in Tax Litigation. A fourth question may arise from the fact that strike insurance has not been declared officially unlawful by any state or federal governmental authority. The legal questions, of course, are not yet settled. If deduction of

⁹¹ Authorities cited at note 11 *supra*. It should be noted, however, that if an alien insurer is used as in the railroad plan there is an additional federal tax consequence. A documentary stamp tax is imposed by the federal government. Strike insurance clearly would be classified as "casualty insurance," and the tax consequently would be four cents on each dollar of the premium charged. INT. REV. CODE OF 1954, § 4371-72. The duty to pay the tax is imposed on any person for whom or in whose name the policy is written, or his solicitor or broker. INT. REV. CODE OF 1954, § 4374. Any such transaction, moreover, is also subject to possible taxation by the country in which the alien insurer does its business in connection with the transaction. On the other hand, use of an alien insurer that is not doing business in the United States is a way of avoiding taxes on premiums by the state where the insured is domiciled or doing business. The Supreme Court has held that the Constitution does not permit a state to levy a tax on premiums paid by such an insured if the contract is entered outside the United States, premiums are paid and the contract is otherwise to be performed outside the United States, the insurer is not doing other business within the state, and the insurer does not have direct contacts with the insured within the state. *Compañía General De Tabacos de Filipinas v. Collector*, 275 U.S. 87 (1927). *Accord*, *State Bd. of Ins. v. Todd Shipyards Corp.*, 340 S.W.2d 339 (Tex. Ct. Civ. App. 1960), *cert. granted*, 368 U.S. 810 (1961). See generally 41 HARV. L. REV. 390 (1928); 26 MICH. L. REV. 803 (1928). Compare *Continental Assur. Co. v. Tennessee*, 311 U.S. 5 (1940); *Connecticut Gen. Life Ins. Co. v. Johnson*, 303 U.S. 77 (1938).

⁹² Confidential materials, *supra* note 6.

strike insurance "premiums" was denied by the Commissioner on the ground of frustration of public policy and the taxpayer litigated the deduction, the court deciding the tax question would not have before it any clear judicial interpretation of the relevant non-tax statutes. A court, particularly one as specialized as the Tax Court, might be reluctant to undertake the complicated task of statutory interpretation and weighing of evidence necessary to determine whether a non-tax statute was violated merely to justify denial of a tax deduction. Moreover, the public policy tax cases refer to a "sharply defined" policy.⁹³ The broad terms of the federal statutes which may bear on strike insurance are the antithesis of a sharp definition. To grant or deny a deduction on the basis of whether statutory language is clear or ambiguous, however, would not provide a standard of any reliability. An approach that appears to avoid serious difficulties would be for the court to say that it will not pass on whether the evidence presented shows that the taxpayer actually was violating the statute, but, for purposes of deduction, to the best of its knowledge the payments do or do not violate the policy of the uninterpreted non-tax statute.⁹⁴ This should avoid use of the tax decision as direct authority in a similar case brought directly for violation of the non-tax statute involved. Additionally, it could not then be said that the federal tax laws encourage any frustration of federal or state governmental policy. Moreover, this approach would avoid the problem of discriminatory treatment of taxpayers that otherwise would be presented if the taxpayer in question had not been sued or prosecuted under the non-tax statute for purely practical reasons.

III. PROCEEDS

Indemnity payments received by a struck firm pursuant to a strike insurance agreement can be expected to be classified as "gross income" under section 61 (a).⁹⁵ Subsection 2 of that provision specifically provides that gross income includes "gross income derived from business . . .,"⁹⁶ and it seems clear that insur-

⁹³ *E.g.*, *Lilly v. Commissioner*, 343 U.S. 90, 96 (1951).

⁹⁴ This approach was taken in a recent Tax Court case involving the old § 302 of the Labor Management Relations Act, ch. 120, 61 Stat. 157 (1947). See Basil Christodoulou, 1962 P-H Tax Ct. Rep. & Mem. Dec. ¶ 62004.

⁹⁵ INT. REV. CODE OF 1954, § 61 (a).

⁹⁶ INT. REV. CODE OF 1954, § 61 (a) (2).

ance proceeds are ordinary income if they represent reimbursement for loss of income resulting from injury to the business. But if part or all of the proceeds are used to replace property damaged in the course of the strike (*e.g.*, through violence, lack of use, or by the process of shutting down operating facilities), a taxpayer may be able to claim *pro tanto* non-recognition under the provisions of section 1033 (a)⁹⁷ by drawing an analogy to the treatment of use and occupancy insurance proceeds under that section.⁹⁸

Like strike insurance, use and occupancy insurance indemnifies a business against losses incurred through the interruption of its operations; it differs from strike insurance in that the risk insured against is interruption of the use of specific property due to a casualty loss such as fire or explosion. Section 1033 (a), providing for the non-recognition of gain realized by the involuntary conversion of property, may be applied by the taxpayer to use and occupancy proceeds when they are expended in the acquisition of property similar or related in service to the property destroyed,⁹⁹ even though it is not the property as such that is insured but only its use.¹⁰⁰ In such cases, the taxpayer is accorded non-recognition if his indemnity contract provides for payment of a *flat per diem allowance* from the date the property is destroyed to the time when replacement could be made and operations resumed with the use of ordinary diligence. On the other hand, section 1033 (a) is not applied to the proceeds of a use and occupancy insurance contract when the language of the policy is in terms of indemnity for *loss of net profits*. The "profits" language seems to stand in the way of finding an involuntary conversion of property, and such proceeds are always classified as gross income under section 61 (a).¹⁰¹

⁹⁷ INT. REV. CODE OF 1954, § 1033 (a).

⁹⁸ See Merritt, *Taxation of Proceeds of Use and Occupancy, or Business Interruption, Insurance*, 1954 INS. L.J. 475.

⁹⁹ Williams Furniture Corp., 45 B.T.A. 928 (1941), *acq.*, 1942-1 CUM. BULL. 17; Flaxlinum Insulating Co., 5 B.T.A. 676 (1926), *acq.*, VI-1 CUM. BULL. 2 (1927), *withdrawn & nonacq.*, X-1 CUM. BULL. 79 (1931), *withdrawn & acq.*, 1942-1 CUM. BULL. 6; Piedmont-Mt. Airy Guano Co., 3 B.T.A. 1009 (1926), *acq.*, V-2 CUM. BULL. 3 (1926), *withdrawn & nonacq.*, X-1 CUM. BULL. 89 (1931), *withdrawn & acq.*, 1942-1 CUM. BULL. 13.

¹⁰⁰ Piedmont-Mt. Airy Guano Co., *supra* note 99. "The use of a certain object or thing belonging to a person is an indispensable part of that individual's property in the object or thing." *Id.* at 1015.

¹⁰¹ Miller v. Hocking Glass Co., 80 F.2d 436 (6th Cir. 1935), *cert. denied*, 298 U.S. 659 (1936); Oppenheim's, Inc. v. Kavanagh, 90 F. Supp. 107 (S.D. Mich. 1950) (issue III); Massillon-Cleveland-Akron Sign Co., 15 T.C. 79 (1950) (issue 2); Treas. Reg. § 1.1033 (a)-3.1033 (f) (1957); O.D. 645, 3 CUM. BULL. 89 (1920).

Both the newspaper and railroad strike insurance contracts specify a daily indemnity that is not affected by the size of lost profits. Thus, proceeds received by a struck newspaper or railroad would be more analogous to the flat per diem amount classification of use and occupancy insurance proceeds than to the category for reimbursement of the loss of net profits. Nevertheless, in most situations, the proceeds of both plans, by analogy, would be classified as income because ordinarily there will be little or no property destroyed as a result of a strike which could be replaced with the proceeds.

The application of the use and occupancy insurance analogy to the airlines mutual assistance agreement, however, involves a different problem. The proceeds are clearly not a flat per diem amount. On the other hand, they are not an estimate of lost profits or computed from the past profits of the airline *suffering* a strike. If the taxpayer argued non-recognition of certain proceeds, it seems likely that the Commissioner would use the fact that the "premiums" are based on increased profits of non-struck carriers as an argument that the proceeds are more analogous to a reimbursement of lost profits than to a flat per diem amount.

All in all, it is unlikely that a struck airline could treat the funds it received in any other way than as income. The payments received could not be classified as a gift.¹⁰² To qualify as a gift, a transfer must be voluntary and without consideration; it must not be made in discharge of a legal or moral obligation.¹⁰³ Still, the question whether a transfer is a gift ultimately must be based on the experience the trier of fact has had with human conduct.¹⁰⁴ However, the fact that the airlines payments are made pursuant to contract and, hence, for consideration ought to answer the question.

Even if strike insurance proceeds are recognized as income, expenditures from them will be deductible under section 162 (a) if they are ordinary and necessary business expenses. Of course,

¹⁰² If money received by a taxpayer is "property acquired by gift," INT. REV. CODE OF 1954, § 102 (a) excludes it from gross income, and it receives more favorable tax treatment than ordinary income. Compare INT. REV. CODE OF 1954, § 2502 with INT. REV. CODE OF 1954, § 1.

¹⁰³ *Robertson v. United States*, 343 U.S. 711 (1952); *Commissioner v. Jacobson*, 336 U.S. 28 (1949); *Bogardus v. Commissioner*, 302 U.S. 34 (1937); *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929).

¹⁰⁴ *Commissioner v. Duberstein*, 363 U.S. 278, 289 (1960), discussed in 59 MICH. L. REV. 321 (1960).

if the proceeds are used to purchase capital items they could not be deducted immediately, but would be depreciable over the life of the assets.¹⁰⁵ Thus, the effect of the income-recognition question will usually be reflected in the time at which taxes are paid rather than the amount that is due eventually. Non-recognition, of course, usually would be preferable because it allows the taxpayer to use the funds that would otherwise be paid to the Treasury as a tax on strike insurance proceeds in the period from the date the income tax is paid until the date when a deduction can be taken on a tax return.

IV. CONCLUSION

In brief, deductibility of the cost of strike insurance seems likely, at least at the present time. It is, however, open to some question and, of course, will be affected by judicial developments in the application of non-tax statutes to strike insurance. Indemnity payments, the "proceeds" of strike insurance, can be expected to be treated as ordinary income, at least in the typical situation.

Deduction of strike insurance "premiums," however, is probably crucial to the continued existence of the present strike insurance arrangements. Without deductibility the dollars spent by a corporation for strike insurance would be worth only one half as much as dollars spent for other items that are deductible, because of the fifty-two percent corporate tax rate.¹⁰⁶

For better or worse, strike insurance is related to a problem that gives rise to strong feelings—the collective bargaining process and the balance of power between labor and management. Hopefully, the courts will not allow themselves to be influenced in any way by personal views in charting the development of tax law theories when they decide the tax questions presented by the business relationships classified as strike insurance.

Robert A. Butler, S.Ed.

¹⁰⁵ See INT. REV. CODE OF 1954, §§ 167, 263.

¹⁰⁶ See INT. REV. CODE OF 1954, § 11.