

# Disproportionate Advances by Shareholders of Subchapter S Corporation and the One Class of Stock Requirement

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## NOTES

### DISPROPORTIONATE ADVANCES BY SHAREHOLDERS OF SUBCHAPTER S CORPORATION AND THE ONE CLASS OF STOCK REQUIREMENT

International Meadows, Inc., a California Corporation incorporated in 1962 for the purpose of operating a golf driving range, filed a timely election to be taxed as a small business corporation under Subchapter S of the Internal Revenue Code of 1954.<sup>1</sup> Disproportionate advances were made by the shareholders of International Meadows when the corporation issued non-interest bearing notes to the partners of its predecessor partnership in exchange for all the assets of that partnership.<sup>2</sup> *Held*, the fact that "debt" characterized as "equity" capital may be disproportionate to the respective common stock interest of the shareholders is not to be regarded as controlling with respect to the question of whether there is more than one class of stock within the meaning of section 1371 (a). "[W]hether the notes in question can be considered as 'debt' or as 'equity' under other provisions of the internal revenue laws, for the purpose of section 1371 such notes do not change the character of the common stock so as to give rise to more than one class of stock."<sup>3</sup> *James L. Stinnett, Jr. v. Commissioner*, 54 T.C. No. 20 (Feb. 11, 1970).

The Technical Amendments Act of 1958<sup>4</sup> established Subchapter S of the Internal Revenue Code of 1954, which provides a method by which a small business corporation may elect to be taxed similar to a partnership. Section 1371 (a) defines a small business corporation as a corporation which, among other things, does not have more than one class of stock. The committee hearings on the Technical Amendments Act of 1958 provide no insight into what was contemplated as constituting more than one class of stock. Those hearings merely set forth the basic congressional intent for enacting Subchapter S as providing the

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1. All statutory references are to the Internal Revenue Code of 1954 unless otherwise specified.

2. The disproportionate advances were created when the predecessor partnership of International Meadows, Inc., the J.B.J. Company, transferred all of its assets to International Meadows in exchange for non-interest bearing corporate notes payable to each partner of J.B.J. Company in an amount equal to the balance of his capital account as of May 31, 1962. The capital accounts of J.B.J. Company as of May 31, 1962, did not reflect the percentage ownership of the partnership, which percentage was equal to the proportionate ownership of the successor corporation, International Meadows, Inc.

3. *James L. Stinnett, Jr. v. Commissioner*, 54 T.C. No. 20 (Feb. 11, 1970); P-H 1970 TAX CT. REP. & MEM. DEC. ¶ 54,20, 54-162; CCH 1970 TAX CT. REP. Dec. 29,955, 2331.

4. H.R. 8381, 85th Cong., 2d Sess. 160 (1957).

capability for a small business "to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence."<sup>5</sup> When the Revenue Act of 1964 was passed, no effort was made to clarify the definition of a second class of stock within the meaning of section 1371.<sup>6</sup> The only record of the actual underlying intent of the one class of stock requirement appears to be the committee hearings on a very similar act proposed in 1954, which the Senate passed but which was not incorporated into the final law.<sup>7</sup> These hearings stipulate that "[i]n order to avoid possible complications in the taxation of preferred stock dividends not earned in the year distributed, only corporations having one class of stock outstanding may qualify."<sup>8</sup>

This underlying congressional intent of the one class of stock requirement was quickly buried beneath a deluge of commissioner regulations. Although the temporary regulations concerning section 1371 did not elaborate on what constituted a second class of stock,<sup>9</sup> the amendment to that regulation, promulgated fifteen months later, stipulated in part that "[i]f an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock."<sup>10</sup> Based on this definition, early cases<sup>11</sup> involving advances to a corporation by its shareholders were resolved by determining whether the obligation was debt or equity.<sup>12</sup>

The traditional debt-equity test was rejected in *Gamman v. Commissioner*,<sup>13</sup> and a somewhat different approach was pro-

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5. S. REP. NO. 1983, 85th Cong., 2d Sess. 87 (1958).

6. See S. REP. NO. 830, 88th Cong., 2d Sess. 146 (1964).

7. H.R. 8300, 83d Cong., 2d Sess. 317 (1954).

8. S. REP. NO. 1622, 83d Cong., 2d Sess. 119 (1954).

9. See Treas. Reg. § 1.1371, T.D. 6317, 1958-2 CUM. BULL. 1096.

10. Treas. Reg. § 1.1371-1(g), T.D. 6432, 1960-1 CUM. BULL. 321.

11. See *Henderson v. United States*, 245 F. Supp. 782 (M.D. Ala. 1965); *Hoffman v. Commissioner*, 47 T.C. 218 (1966); *Seven Sixty Ranch Co. v. Kennedy*, 17 Am. Fed. Tax R.2d ¶ 66-176; 66-1 U.S. Tax Cas. ¶ 9293; *Catalina Homes, Inc. v. Commissioner*, P-H TAX CT. MEM. 1964-225, 23 CCH TAX CT. MEM. 1361.

12. In *Catalina Homes, Inc.* the court rejected the plea of proportionality of the shareholder advances by saying "it is of no significance whether the advances . . . were proportionate to their stockholdings; for respondent . . . has called our attention to other factors indicating that their advances were placed at the risk of the business." *Catalina Homes, Inc. v. Commissioner*, P-H TAX CT. MEM. 1964-225, 64-1499; 23 CCH TAX CT. MEM. 1361, 1367. The plea of proportionality of advances was later recognized in *Gamman v. Commissioner*, 46 T.C. 1 (1966).

13. 46 T.C. 1 (1966).

posed by the court to determine whether shareholder advances constituted a second class of stock. The advances in *Gamman* were found to be equity, but not a second class of stock "because the advances were made and the notes were held by the shareholders in direct proportion to their stockholdings."<sup>14</sup> Moreover, the court declared the last sentence of regulation § 1.1371-1 invalid.<sup>15</sup> Shortly thereafter, the regulation was amended to read as it does today.<sup>16</sup> Under the regulation § 1.1371-1 as amended by Treasury Decision 6904,<sup>17</sup> the court replaced the debt-equity analysis with a simple test of the proportionality of the advances.<sup>18</sup> If the advances were found to be in the same proportion as the common stockholdings, it was deemed immaterial whether the advances were loans or equity; they simply did not constitute a second class of stock.

*Portage Plastics Co. v. United States*<sup>19</sup> was the first case which expressly looked beyond the commissioner's regulations and evaluated the underlying congressional intent for establishing the one class of stock requirement. After determining that the advances to the corporation by the shareholders were contributions to capital which were disproportionate to their common stock interest, the court proceeded to present a comprehensive review of the applicable legislative history. It based its decision upon the interpretation and application of the language con-

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14. *Id.* at 9.

15. The last sentence of regulation § 1.1371-1 stated: "[i]f an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock." Treas. Reg. § 1.1371-1(g), T.D. 6432, 1960-1 CUM. BULL. 321.

16. The last sentence of Treasury Regulation § 1.1371-1g (T.D. 6432, 1960-1 CUM. BULL. 321) was deleted and the following inserted. "Obligations which purport to represent debt but which actually represent equity capital will generally constitute a second class of stock. However, if such purported debt obligations are owned solely by the owners of the nominal stock of the corporation in substantially the same proportion as they own such nominal stock, such purported debt obligations will be treated as contributions to capital rather than a second class of stock. But, if an issuance, redemption, sale, or other transfer of nominal stock, or of purported debt obligations which actually represent equity capital, results in a change in a shareholder's proportionate share of nominal stock or his proportionate share of such purported debt, a new determination shall be made as to whether the corporation has more than one class of stock as of the time of such change." Treas. Reg. § 1.1371-1(g), T.D. 6904, 1967-1 CUM. BULL. 219.

17. *Id.*

18. See *Raynor v. Commissioner*, 50 T.C. 762 (1968); *Lewis Building and Supplies, Inc. v. Commissioner*, P-H TAX CT. MEM. 1966-159; 25 CCH TAX CT. MEM. 844; *Nielson v. Commissioner*, P-H TAX CT. MEM. 1968-11; 27 CCH TAX CT. MEM. 44; *Novell v. Commissioner*, P-H TAX CT. MEM. 1969-225; 28 CCH TAX CT. MEM. 1307.

19. 301 F. Supp. 684 (W.D. Wis. 1969); 24 Am. Fed. Tax R.2d ¶ 60-5086; 69-2 U.S. Tax Cas. ¶ 9593.

tained in the committee reports concerning the 1954 bill stating that the reason for requiring only one class of stock was to "avoid possible complications in the taxation of preferred stock dividends not earned in the year of distribution."<sup>20</sup> It found that where the interest on advances was to be paid only out of net profit before taxes, no possible complication in the taxation of the preferred dividends not earned in the year of distribution could arise.<sup>21</sup>

The instant case is an extension of the result reached in *Portage Plastics*, but it takes a completely different approach. In *Stinnett*, the court specifically declared regulation § 1.1371(g) invalid as applied to the facts presented.<sup>22</sup> The majority opinion vaguely rested its determination that the disproportionate equity advances were not a second class of stock on the basic purpose of Subchapter S. The reasoning in the majority opinion stemmed primarily from the fact that section 1376(b)(2) contemplates shareholder advances to a small business corporation.<sup>23</sup> There were, however, two separate concurring opinions representing the opinion of eleven judges and a dissent supported by six judges. Although the justices disagreed on why no second class of stock existed, the fact remains that this case was the first in which the Tax Court found disproportionate equity advances not a second class of stock.

It is submitted that the Tax Court reached the proper conclusion in *Stinnett*, but it should have rested its decision on reasoning similar to that applied in *Portage Plastics*. As pointed out previously, the only record of the actual underlying intent of the one class of stock requirement is the committee report on the 1954 act which states that "[i]n order to avoid possible complications in the taxation of preferred stock dividends not earned in year distributed, only corporations having one class of stock outstanding may qualify."<sup>24</sup> An analysis of this "complication" will indicate the problems which the redactors foresaw and their underlying intent for requiring that a corporation have only

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20. S. REP. No. 1622, 83d Cong., 2d Sess. 119 (1954).

21. See *Portage Plastics Co. v. United States*, 301 F. Supp. 684, 693 (W.D. Wis. 1969); 24 Am. Fed. Tax R.2d ¶ 69-5086, 69-5308; 69-2 U.S. Tax Cas. ¶ 9593, 85591.

22. P-H 1970 TAX CT. REP. & MEM. DEC. ¶ 54.20, 54-163; CCH 1970 TAX CT. REP. Dec. 29,955, 2332.

23. See note 22 *supra*.

CCH 1970 TAX CT. REP. Dec. 29,955, 2332.

24. S. REP. No. 1622, 83d Cong., 2d Sess. 119 (1954).

one class of stock. This analysis will also indicate why the reasoning in *Stinnett* is consistent with that congressional intent.

If a small business corporation with two classes of stock, "preferred"<sup>25</sup> and common, retained the profits of a given year, under Subchapter S they would become undistributed taxable income of the corporation and thus taxable income to the *common* shareholders for that year. If in the following year the corporation had no profits but paid "dividends" to the "*preferred*" shareholders out of those retained earnings, a problem of possible double taxation of those "dividends" was apparently foreseen by the redactors. These "dividends" would be taxable income of the "preferred" shareholder even though the common shareholders had previously paid taxes on that same amount as undistributed taxable income of the corporation for the prior year. The complexity in the administration of this possible double taxation of the "preferred dividends" is the complication the redactors foresaw<sup>26</sup> and attempted to avoid via the one class of stock requirement.<sup>27</sup>

In further illustrating the administrative complexity foreseen by the redactors, it is helpful to analyze the following three sets of elements deemed critical by the court in determining whether shareholder advances created a second class of stock:

- (1) the debt or equity character of the advances,
- (2) the proportionality or disproportionality of the advances, and
- (3) the "dividends" paid on the advances being either less or greater than current earnings.

These three sets of elements combine to produce the following eight possible situations involving shareholder advances:

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25. Since a Subchapter S corporation may not have a second class of stock outstanding, it may not have preferred stock or pay preferred dividends. However, for the purposes of this analysis they are referred to as preferred with the word enclosed in quotation marks to distinguish such advances and distributions from true preferred stocks and dividends.

26. See McGaffey, *The Requirement that a Subchapter S Corporation May Have Only One Class of Stock*, 50 MARQ. L. REV. 365, 368 (1966).

27. There appear to be possible arguments that the one class of stock requirement is an effort to prevent liquidation, dividend, and voting advantages of one group of shareholders over others. However, these arguments appear to have been created after the enactment of the statute as there is no mention of these advantages in the committee hearings. See S. REP. NO. 1622, 83d Cong., 2d Sess. 119, 452-55 (1954); S. REP. NO. 1983, 85th Cong., 2d Sess. 87-89, 216-26 (1958); S. REP. NO. 830, 88th Cong., 2d Sess. 146-47 (1964).

- (1) debt advances that are proportionate, the "dividends" on which are less than current earnings,
- (2) debt advances that are proportionate, the "dividends" on which are greater than current earnings,
- (3) debt advances that are disproportionate, the "dividends" on which are less than current earnings,
- (4) debt advances that are disproportionate, the "dividends" on which are greater than current earnings,
- (5) equity advances that are proportionate, the "dividends" on which are greater than current earnings,
- (6) equity advances that are proportionate, the "dividends" on which are greater than current earnings,
- (7) equity advances that are disproportionate, the "dividends" on which are less than current earnings, and
- (8) equity advances that are disproportionate, the "dividends" on which are greater than current earnings.

The following example illustrates the effects of these eight possible situations. Assume that small business corporation X has, before interest deduction or dividend distribution, earnings of \$10,000 in year 1 which are retained in the business and no earnings or losses in year 2. Shareholders A and B each own fifty per cent of the stock of corporation X, and A has advanced the corporation an additional \$10,000 at a rate of six percent.

In the first four debt-advance situations, the \$10,000 advanced by A is considered a loan, and the \$600 (6% x \$10,000) paid to A is interest. This interest is a deductible expense of the corporation, thus reducing the earnings to \$9,400 of taxable income.<sup>28</sup> The undistributed taxable income of \$9,400 is taxed \$4,700 each to A and B under section 1373. The \$600 interest

	Year 1	Year 2
28. Income before interest or dividends	\$10,000	—0—
Less interest expense	600	\$ 600
Net taxable income or (loss)	<u>\$ 9,400</u>	<u>(\$ 600)</u>
Taxable income of shareholder:		
A Undistributed taxable income of X	\$ 4,700	(\$ 300)
Interest income	600	600
Total taxable income of A	<u>\$ 5,300</u>	<u>\$ 300</u>
B Undistributed taxable income of X	<u>\$ 4,700</u>	<u>(\$ 300)</u>

which A received is ordinary income taxable to him personally. In the following year the interest paid produces a corporate loss of \$600 and is treated as a \$300 loss each to A and B. Here again, A has \$600 of taxable interest income. Since the full amount of undistributed taxable income was taxed to the shareholders (\$5,300 to A, \$4,700 to B in year 1; \$300 to A, and \$300 loss to B in year 2), the administrative complexity of double taxation of the \$600 does not exist in the case of debt advances. It is immaterial whether the advances are proportionate or disproportionate or whether the interest paid is less than or in excess of current earnings. The same result would be reached in each case as the example indicates.

In the case presented by situations five and six, the advances are equity but they are proportionate to the common shareholder interest. To create such a situation, the above example must be amended so that shareholder A and shareholder B have each advanced the corporation \$10,000 which represents equity capital. The effect of such an arrangement is merely an increase in the capital base of the corporation. Thus, the capital investment of each shareholder remains proportionate to his common stock interest. Whatever the corporation makes as profit becomes income to the shareholder in the same manner and in the same proportion as if no advances had ever been made to the corporation. This position was recognized by the court in *Gamman* where it was stated that "the notes would have to be considered a nullity insofar as they purported to give petitioners any rights and interests in the income and assets of the corporation different from the rights and interests they had as owners of all the capital stock of the corporation."<sup>29</sup> The commissioner has acquiesced in this position by amending the regulations.<sup>30</sup>

In resolving the example under this situation, the \$10,000 of taxable income for the corporation in year 1 is taxed \$5,000 to A and \$5,000 to B, and each shareholder reports no gain or loss in year 2.<sup>31</sup> If it is assumed that A and B are each paid \$600

29. *Gamman v. Commissioner*, 46 T.C. 1, 9 (1966).

30. See Treas. Reg. § 1.1371-1(g), T.D. 6904, 1967-1 CUM. BULL. 219.

	Year 1	Year 2
31. Income before interest or dividends	\$10,000	—0—
Dividends	600	\$ 600
Net taxable income or (loss)	<u>\$10,000</u>	<u>—0—</u>
Taxable income of shareholder:		
A Undistributed taxable income of X	<u>\$ 5,000</u>	<u>—0—</u>
B Undistributed taxable income of X	<u>\$ 5,000</u>	<u>—0—</u>

in "preferred dividends," no problem arises. Remembering that the functional tax structure of a Subchapter S corporation is similar to a partnership, one should conclude that any funds distributed to A and B in year 2 are not "preferred dividends" but distributions of prior taxed income.<sup>32</sup> Since a shareholder may receive up to the amount of his prior taxed income as non-taxable corporate distributions,<sup>33</sup> the previously mentioned administrative complexity in the taxation of preferred dividends does not occur. If for some reason only one of the shareholders, shareholder A, receives this distribution in year 2, the same result would be reached so long as the distribution is not in excess of his share of the undistributed taxable income as prescribed in section 1375(d) (2). This is true because the distribution received by shareholder A should merely be considered a withdrawal of his prior taxed income. Since the profits were shared equally by shareholders A and B in year 1, B has a similar claim against the corporation which is represented in his share of the prior taxed income remaining in the corporation.<sup>34</sup> If the distribution to one of the shareholders is in excess of his prior taxed corporate income, then a portion of the distribution must be considered a repayment of the advance and disproportionate advances are created—a completely different situation. But in all cases of proportional advances, the administrative complexity in the taxation of preferred dividends is not created.

The final two situations, seven and eight, present cases of disproportionate equity advances. In these cases, so long as the total dividends distributed do not exceed the current earnings, the problem of taxation of "preferred dividends" does not arise.

32. Assuming that there are no other distributions to shareholders other than the \$600 each to A and B, the result of this allocation on the prior taxed income would be as follows:

	At end of Year 1	At end of Year 2
Prior taxed income of shareholder:		
A	\$ 4,400	\$3,800
B	4,400	3,800

33. INT. REV. CODE of 1954, § 1375(d).

34. Assuming that there are no other distributions to shareholders other than the \$600 to A, the result of this allocation on the prior taxed income would be as follows:

	At end of Year 1	At end of Year 2
Prior taxed income of shareholder:		
A	\$ 4,400	\$3,800
B	4,400	4,400

This type situation can be illustrated by year 1 of the original example. In that example shareholder A had advanced the corporation \$10,000; the corporation had earnings in year 1 of \$10,000, and it paid \$600 to shareholder A as preferred dividends. Internal Revenue Code section 1373 (c) defines undistributed taxable income as taxable income minus the amount of money distributed as dividends during the taxable year plus certain taxes. Thus, the undistributed taxable income of corporation X for year 1 is \$9,400 (\$10,000 minus \$600 dividends). Internal Revenue Code section 1373 (b) provides only that each shareholder shall include in his gross income his proportionate share of the undistributed taxable income. In this case shareholder A and B each include \$4,700 in their gross income as their share of the undistributed taxable income of the corporation. Additionally, shareholder A must include in his gross income the \$600 dividend paid to him by corporation X.<sup>35</sup> As this example indicates, where the advances are disproportionate equity advances, so long as the dividends distributed are less than current earnings no complication in the taxation of these "preferred dividends" is created.

However, in the final situation, where disproportionate equity advances exist and dividends are paid in excess of current earnings, the complication arises exactly as the redactors of Subchapter S foresaw. Year 2 of the original example illustrates this last situation. There the corporation had no income but paid "preferred dividends" of \$600 to shareholder A. Since no current earnings exist, the distribution must be considered a distribution of a prior year's earnings.<sup>36</sup> However, these prior earnings have previously been taxed as undistributed taxable income. This \$600 thus becomes subject to a second taxation,

	Year 1
35. Income of X before dividends	\$10,000
Dividends paid to shareholder B	600
Undistributed taxable income of X	<u>\$ 9,400</u>
Taxable income of:	
Shareholder A:	
Undistributed taxable income of X	\$ 4,700
Dividends distributed by X	600
Total	<u>\$ 5,300</u>
Shareholder B:	
Undistributed taxable income of X	<u>\$ 4,700</u>

36. See Treas. Reg. § 1.1375-4(b), T.D. 6432, 1960-1 CUM. BULL. 344.

which Subchapter S was designed to avoid, unless the distribution qualifies as a non-taxable distribution under section 1375 (d).

If it is assumed that this \$600 distribution qualifies as a non-taxable distribution of prior taxed income, an administrative problem arises. If the \$600 is merely considered a withdrawal of one shareholder's portion of the prior taxed income, the corporation has in fact not paid him any "preferred dividend" on the \$10,000 advance, because it merely distributed to that shareholder funds to which he already had a claim. This is not what the corporation intended to do; it intended to pay shareholder A an additional \$600 as a return on his advance. On the other hand, if this distribution is considered a distribution of the corporation and as such chargeable proportionally to each of the shareholder's prior taxed income, a different problem arises. This arrangement would result in shareholder A receiving, tax free, \$300 of shareholder B's prior taxed income. This situation permits shareholder A to receive income which has previously been taxed to shareholder B—a situation wholly untenable.<sup>37</sup>

Therefore, where the advances are disproportionate and dividends are paid in excess of current earnings, either a problem in the taxation of the dividends is created or a problem in the proper allocation of the distribution of prior taxed income arises. The redactors only foresaw the possible problem resulting in the double taxation of these preferred dividends, but as indicated the alternative possibility proves equally undesirable.

It is submitted that the underlying reason for the confusion in this area results from an attempt to resolve the issue by applying a single test where the three separate tests are needed. The court should raise the following three questions to determine whether a second class of stock exists under section 1371 (a) (4):

- (1) Are the advances debt or equity?
- (2) Are the advances proportionate or disproportionate?

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37. In this example only \$300 of B's after tax dollars were withdrawn tax free by A. However, as the advances become larger, with higher interest rates and greater disproportionality, the tax avoidance siphoning increases. If A had advanced the corporation \$100,000 at ten percent with B making no advances and if A owned one percent of the stock and B 99 percent, then in the example presented, A could have siphoned off the full \$9,900 of B's prior taxed income. This is inequitable itself, but if it is assumed that A is in a 70 percent bracket and B is in the 14 percent bracket, then the inequity becomes even more pronounced.

(3) Were dividends distributed which were less than the current earnings or in excess of current earnings?

As shown by the previous analysis, only where the advances are equity advances which are disproportionate to the common stock interest with dividends paid which are in excess of current earnings does a second class of stock exist within the congressional intention of section 1371 (a) (4).

It was previously stated that the court reached the correct result in *Stinnett*. To verify that statement the above tests are applied to the facts of that case. The court clearly stated that it construed the advances to be equity advances, and petitioner admitted that the advances were disproportionate. However, since the notes were non-interest bearing, no "preferred dividends" were paid. Therefore, no dividends were distributed in excess of current earnings, and the stock did not constitute a second class of stock.

Since regulation § 1.1371 (g) was declared invalid as applied to the facts of *Stinnett*, hopefully the commissioner will acquiesce to that position and amend the regulations to provide the three step test to determine whether advances constitute a second class of stock. Such a test would make the regulation in agreement with the congressional intent prohibiting a second class of stock and would put at rest a controversy which remains unsettled after twelve years of existence.

*J. Edgerton Pierson, Jr.*

COMPULSORY AGREEMENT TO SUBSTANTIVE PROVISIONS:  
A REMEDY NOT ALLOWED

The National Labor Relations Board found the company's refusal to bargain about a checkoff clause was not made in good faith and was done solely to frustrate the making of any collective bargaining agreement. The Court of Appeals for the District of Columbia approved this finding.<sup>1</sup> That court also enforced the Board's order to the company to cease and desist from refusing to bargain in good faith and to further bargain over the checkoff if the union so requested. The court implied that the Board could require the company to agree to a checkoff

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1. *United Steelworkers v. NLRB*, 363 F.2d 272 (D.C. Cir. 1966).